Free Market Center

TWO YEARS OF REFORM IN SERBIA: A WASTED OPPORTUNITY

Free Market Center Team

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«We got rid of Milošević relatively easily, but it is much more difficult to get rid of communism»[1], may be a summary of what happened in Serbia after the 18th members coalition of DOS (Democratic Opposition of Serbia) took power on the Belgrade's streets from Milošević's regime on October 5, 2002. The DOS leaders have promised deep reforms to reintegrate the country into the world community, to recover the economy, to establish democracy and to start implementing the rule of law. Two years therafter, not only that promises are not at least partly fulfilled, but also the comittment to reforms is lacking. New authorities have undergone the illusion that wrong was people in power rather than the system. The DOS continued to rule by keeping the old system with minor changes, which do not pose its nature into question, and this has prevented larger positive policy changes.

In what follows, this is documented in larger policy areas. Priority is given to economy, while the state, legal system and politics are covered to lesser degree, just in order to provide a necessarily context.

A. INTRODUCTION

After nearly five decades under Tito's communism, the nationalistic tendencies grow in Yugoslavia (SFRY) in 1980-ies that finally led to disintegration of the country at the beginning of 1990-ies. Serbia and Montenegro have formed a temporary Federal Republic of Yugoslavia (FRY) in 1992, after the majority of Yugoslav nations has seceded and formed their nation states - Slovenia, Croatia, Bosnia & Herzegovina and Macedonia. FRY was dominated by a national-socialist regime of Slobodan Milošević that emerged in Serbia. Due to either aggressive or incompetent policies, Serbia and FRY came under diplomatic pressure, followed by the comprehensive sanctions of the UN (May 1992 – November 1995) and the NATO intervention on Kosovo in 1999. GDP fell for more than 50% from 1989 to 1999, and GDP *per capita* slid down from nearly 3,000 USD to 1,200 USD in 1999. From 2000 on, GDP is on rise and it is estimated by the International Monetary Fund (IMF) to 1,800 USD in the midst

[1] M. Prokopijevic, in: Rubin, A. 2001.

of 2002.[2] Industrial production[3] was down 75% at the end 1990-ies, foreign debt up to 12.5bn USD, i.e. equal to the GDP. Cumulative losses in economy in 2000 were 9bn USD, while short term debts reached 14bn USD.[4] Official unemployment rate was 28%, while unofficial unemployment soared to 50% in 1999. Gray economy has created an equivalent to 40-50% of GDP. Imports were covered by exports for 78% in 1990 and for 40% in 2001. Inflation rate moved 40 – 200% in 1990-ies, with the hyperinflation in 1992-1993, close to its heights in Germany after the IIWW.

Bad and expensive policies have deprived Milošević of popular support over time, and he finally lost federal presidential elections from September 24, 2000. against Vojislav Koštunica, representing the coalition of the DOS. Milošević's hesitation to accept electoral results and rumors on his eventual coup forced hundreds of thousands on the Belgrade streets, facilitating his demise from power on October 5, 2000. Everything seemed to be pink, since on the Serbian parliamentary election, held on December 23, 2000, the DOS won a huge majority by getting 176 out of 250 seats in the Serbian Parliament.

As a result of huge victory of "democratic forces", the DOS took over the Serbian government on January 22, 2001. Prime minister Zoran Đinđić said, the government "got the mandate to implement reforms, rather than just to rule".[5] He said, it is "the government of large reforms and energetic actions" that adopts "strategy of attracting foreign investments" and that Serbia needs a "new deal". Đinđić said, "He expects large FDI in agriculture, infrastructure and energy sector".[6] He promised to solve open questions, for example, to establish relationships with Montenegro on the new basis, and to fight terrorism in southern Serbia. Đinđić has promised finally "to investigate and solve the heaviest crimes, killings and kidnapping" from Milosevic's era, including investigation of involvement of state agencies and secret police into larger crimes.[7]

The expose by Đinđić was a mixture of false promises and wrong ideas. "New deal" was a bad idea even when invented, and its status should worsen in our age

[2] Contrary to IMF, EBRD (2002) estimates GDP *per capita* to just 1200 euro.
[3] Cf. Raičević & Šuković (Eds)(2002), Preface, p. 8. Industrial production in June 2002. was down 1.2% compared to June 2001. Cf. Dumezić 2002, p. 26. Cf. Table 1.
[4] Cf. Raičević & Šuković, p. 8.
[5] Đinđić 2001, p. 1.
[6] Ibid, p. 2.
[7] Ibid, p. 1.

of globalization. Deep reforms and larger investments are still missing today as they did two years ago. None of the political crimes from Milošević's era was solved, since Đinđić took previous police bosses under his personal protection, while the new cases emerged. Actually, criminal agencies dominating the state just have changed the boss, by relying on Đinđić instead of Milošević, while everything goes as before.

Larger powers, international organizations and democratic forces in general have welcomed the demise of Milošević, and as a result of pro-Western, cooperative policy of the DOS, the relationships with the outside world have been improved. States, foundations and non-market funds provided financial support for Serbia ahead of reforms to happen. There were a lot of hopes both inside and outside the country that murky period is over and better time ahead. However, this hopes faded away in less than a year after changes took place, as it became clear that new authorities do intend to preserve the old system rather than to enter serious reforms towards market democracy under the rule of law.

B. ECONOMY

The reliance on bureaucratic control over economy practicized by new government has prevented economic reforms. Even there where some modest reforms were conducted, they were either insufficient or went into wrong direction. By prolonging the rule of bureaucracy over economy the government consolidated the redistribution of poverty instead to trace a path to a flourishing market economy able to grow at a faster pace.

LIBERALIZATION OF THE TRADE REGIME

Foreign trade was during the whole period of Milošević's rule under the strict control, since it was an important source of budget revenues as well as an extra source of profits for a small Milošević's "elite". After changes from October 5th, there was trade liberalization to some extent. It consisted mainly in liberalization of formal procedures (that even previously were not always enforced) and nominal decrease of customs rates.

Insofar conducted liberalization measures include:

- Abolishment of several requirements for doing business in foreign trade, such as: additional registration at the court for the export/import licenses, giving deposit of 10,000 DEM, paying fixed yearly tax of 20,000 YUD, requirement for having more than 3 employees. Thus a majority of the formal entry barriers is removed[8], which ended the practice of indirect import through those companies that were privileged to pass a very biased registration procedure.

- Since June 1, 2001, the new Law on Customs Tariff is in power, and it brought many new propositions:

1. The Customs tariff is harmonized with the EU Combined nomenclature.

2. Tax for customs' notification was cut from 1% to 0.5%.

3. Unique custom rate was cut from 15% to 10% (this rate applies for goods for personal and household use, provided their value is lower than 3,000 USD).

4. Custom rates are varying between 1% and 30%. There are only 6 categories of rates within this range, whilst previously there were 38 different rates (in range between 0 and 40%).

5. For raw material, equipment and spare parts that can not be sourced from Yugoslavia, the custom rate is 1%. If raw material is produced in the country, the rate is 5%, and for equipment in that case it is 10%.

6. The average custom rate has dropped from 14.43% in 2000, to 9.37% in 2001.[9]

7. Some 50.16% of the goods listed undergo the minimum rates set at one and five per cent, for 73.17% of goods applied rates are between 1 and 10%, and 7.6% of goods listed fall into the maximal, 30% - custom category.

8. Customs rates are lowered for 7,099 tariff positions, for 1,116 positions the rates remained the same, and for 330 positions the rates are increased.

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[8] One can frequently read in newspapers that some of the informal restrictions are still in power, thus it can be found even the price for license to import one truck of some of the most profitable goods.

[9] It will be most probably the same in 2002 if the structure of imports remains the same, since this rate uses as ponders quantities of imported goods.

9. Import licenses are still necessary for import of weapons, drugs and for some products of metal industry (since it is expected that Russian producers would enter the market with dumping prices).

FRY has recently established several bilateral free trade agreements, of which only two are now in power – with Russia and Macedonia. Interim Agreements are signed with Bosnia and Hungary. According to the SEE Stability Pact all countries in the region are obliged to liberalize trade throughout the region. Due to bilateral free trade agreements there are cases of re-export; thus Serbia pays the rent to Russian and Macedonian traders for goods coming from the countries with which they have free trade agreements. These rents can be lowered if Serbia continues its liberalization and if it arranges more free trade agreements. In January 2001, FRY has applied for membership in the WTO. In February 2001, it was formed the Working group, and by the end of 2001 the Group has finished a Memorandum on Yugoslav foreign trade. Since nothing else was done, it is unlikely that FRY will enter the WTO before 2005.

All noted measures of trade liberalization and changes done in supporting areas, though encouraging, are insufficient. The following is to illustrate that:

1. There is still too large regulation over this sector as well as too many restrictions that are mainly formulated through various decisions and decrees, thus harming basic rules set by laws, which brought certain liberalization.[10] Other regulations on foreign trade include: 8 decisions, 4 decrees, 2 orders, and 4 other decisions of lower governing levels.

2. Restrictions that are still in power are much higher not only compared to that in the EU, but also to those in the neighboring countries (especially for agricultural products, food, metal products and cars). For example, average custom rates in some transition countries are: Hungary 3.6%, Czech Republic 2.3%, Poland 3.7%, Slovenia 8.8%, Estonia 0%. There are also some quantitative restrains in export. Export quotas are implemented for 34 products, among them the most important are wheat, corn, sunflower seed and – cows. Federal Government decides about the use of quotas and the licenses

[10] Foreign trade regime is mainly defined by the following laws: Foreign Trade Law, Customs Law, Law on Foreign Currency Transactions, Law on International Credits, Law on excise duty, Law on Retail Tax, Law on Tax for Financial Transactions, Law on Fund for Insurance and Finance of Foreign Trade, Concessions Law, Law on Free Trade Zones, Law on Foreign Direct Investments etc.

are issued by Federal Ministry for international economic relations. Government has introduced monopoly on oil imports and a similar monopoly regulation will be applied to tobacco.

3. The administration has reduced its presence in foreign trade sector, but it kept most of the instruments for controlling those involved in this business, and how businesses are going on – thus decreasing competition, making space for corruption and finally raising the costs to businesses.

4. Slow pace in reforming the administration (mainly the Federal, which has the most of the competences in foreign trade) keeps informal restrictions over this sector, supported by the import/export lobbies. Lobbies from Milosevic's era found well connections with the DOS politicians, which is unacceptable for a functional market democracy.

5. Despite a nominal decrease of average customs duties, the real customs have increased, since the calculated duties must be paid in total amount. The calculated duties under previous regime were lower even for 80%, by using official exchange rate that was several times below the market rate.

After all these changes there are some positive trends in foreign trade sector but still it is needed a further deregulation as well as a decrease of influence of informal groups and corruption. There are still a lot of problems: illegal imports (mainly from Kosovo, Bosnia and Herzegovina and from Montenegro), corruption in administration, especially within customs authorities, and policy of exchange rate. Naturally, import-export business largely depends on general conditions for doing business and ability for producing marketable products.

Table 1: Foreign Trade in FRY in millions USD

	1990	**1992**	**1997**	**1998**	**1999**	**2000**	**2001**	**VI 2002**	**I-VI 2002**
Export	5816	2539	2677	2858	1498	1723	1903	156	1199
Import	7460	3859	4826	4849	3296	3711	4837	424	3227
Trade balance	-1644	-1320	-2149	-1991	-1728	-1988	-2934	-268	-2028

Import coverage by export in %	78	65,6	55,6	58,8	45,4	54,3	39,3	36,9	36,3

Source: **Ekonomist magazin**, no 120, September 9, 2002, p. 6.

There was a permanent increase of trade deficit during the 1990-ies, the import coverage by export has dropped from 78% to 36,3%. Insofar the trade deficit is mainly financed by large inflow of private transfers.[11] Constrains for foreign trade are not only non-adequate products, but also the lack of knowledge about the procedures, financial techniques, international regulation, etc. Growing trade deficit will increase the pressure on current macroeconomic balance and exchange rate. Macroeconomic balance and exchange rate will be under a strong pressure because of the lack of reforms in the real sector. It is realistic to assume that current equilibrium on macro level will be harmed in the coming period, most probably between 2004 and 2006, and that might produce a crises like in Bulgaria in 1996. In other words, the macroeconomic stability achieved now in Serbia is temporary.

PRIVATIZATION

After the change from October 2000, it took more than six months, until June 2001, for the new government to legislate the privatization law. That is a long period keeping in mind the facts that Serbia is lagging behind the other transition countries and that some political parties now belonging to the DOS drafted their own proposal back in 1995[12]. That shows that the Serbian Government was not in a rush for reforms and once the law was introduced it turned out to be bad. The selected method of privatization is based on sale of the most of capital through tenders and auctions (up to 70% of the value), free distribution of the remaining part of the ownership (the 30% of the value) and the restructuring of the enterprises for which it is believed that they could not be sold in the present form. The entire concept is formally based on transparency and public

[11] Serbian citizens working abroad support financially their relatives in Serbia.
[12] »The proposal of the privatization law« of the Democratic party based on the voucher method was submitted to the Parliament of Serbia on March 24, 1995 (and was rejected by ruling Milošević's socialists).

competition and, what is important for privatization, its premises are compulsiveness and limited duration – all publicly owned enterprises are to be privatized within four years (until June 2005).

The privatization law is bad because the chosen method of privatization presupposes the wide openness of the market, a very developed financial market and high level of competition, which is not the case in Serbia. If the market is closed one can rely on domestic potential buyers only; if the financial market is not developed then the bureaucratic arbitration is predominant; if there is no high level of competition, then the sale of enterprises turns into the sale of the market. As there is no efficient anti-monopoly law in Serbia, companies get extra rents at the expense of helpless buyers. The law unnecessarily centralizes the process of privatization. Instead of the taking care of about one hundred largest companies and putting everything else into the hands of the local municipalities, the cities (Belgrade, Niš, Novi Sad and Kragujevac) and the province Vojvodina, the Government of Serbia took the responsibility for privatization of all 6000 medium and large companies, in obvious effort to control unemployment and to use the revenues from privatization to finance its own stay in power.[13] In order to conduct the privatization, the Government founded the Agency for privatization, which, in spite of its good will, can not complete the privatization of such a large number of enterprises until 2005, which is the deadline envisaged by the law.

The Agency prepares the enterprises for privatization, undertakes their privatization and <u>controls</u> the process of privatization. That represents the conflict of interests and recalls in advance the proclaimed "transparency" of the process. At the very beginning of the privatization process the Government and the Agency were making naïve mistakes, as if they have learned nothing from privatization in other countries. For example, the Government envisaged the period of 45 days from the day the auction was announced (for the minority package of ownership) and a 15-day deadline for the payment of a deposit before the auction; then, if no one would pay the deposit, the Government would wait for the day of the auction to announce a new auction, which altogether is a waste of time. The Government was pushing for the overestimated value

[13] Only 5% of the revenues goes to a municipality or to a province, 5% goes to the pension fund, 5% in the restitution fund, while the rest goes to the Serbian budget.

of the companies in order to maximize its budgetary revenues.[14] The buyers were compelled into practices not proper to market economy, such as the obligation of having a business plan[15] or the obligation to invest 150% of the redemption value of the company.

The law on privatization envisaged many exceptions, and the following categories do not belong to the privatization scheme: 1. companies belonging to the ex-Yugoslav republics; 2. bankrupted companies; 3. public communal companies;[16] 4. farmers' cooperatives; 5. the high-quality companies. However, the Government does not exclude from privatization companies subject to denationalization (restitution). The exclusion is awarded only in occasions when "The League for the protection of private property" manages to prevent those sales through its immediate actions, such as in the cases of some hotels in Belgrade and Vrnjačka Banja.[17] Although the return of the acquired property was very high on the DOS's electoral agenda in 2000, the Government of Serbia does not even mention the question of denationalization now.[18] Officially, 5% of revenues from sold companies go into a fund which is to be used for the redemption of

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[14] An auction starts with a basic price, equal to 80% of the estimated value of the enterprise, with the public sale towards the higher price. If no one shows interest in a particular enterprise the public sale goes downwards, with the basic price starting from 120% of the estimated value of the enterprise. If only one buyer appears, he is ***obliged*** to accept 80% of the estimated value as the price. The buyers have therefore arranged to come at least in pairs and than try to pay as low price as possible for the enterprise by bidding the price downwards, often paying the deposit only, which was close to one third of the 80% estimated value. The authorities changed the rules in July 2002: the basic price is equal to 20% of the estimated value and the deposit is »somewhat smaller than that«. The value of the enterprise is determined by discounting the net loss of the enterprise from the accounting value of the enterprise and only the upward price biding is permitted.

[15] The business plan was no more an obligation in mid-2002, but the redemption value remained.

[16] Some 11% of total employed workforce in the economy works in publicly owned companies and those companies create 20% of the GDP, but their losses make 27% of the total losses in the economy. Communal companies are only one part of the public companies, but they are also the biggest losers and the biggest debtors to the state (because of unpaid taxes). The Government, still, keeps using these companies for its social policy, the same as Milošević and Tito did before. The minister of finance in the Government of Serbia, Bozidar Đelić, says that the state should invest 27bn USD into these companies by 2010. Cf. L.S. (2002), p. 16. Only a person who does not know what the money is could say such a thing.

[17] So the Government of Serbia sold the cement-production factory in Beočin, although that factory was nationalized by the Tito's communists after 1945. In Belgrade there are open sales of the city building ground which was also nationalized after 1945, although the inheritors of the former owners protested, and in one case the American embassy in Belgrade protested as a legal representative of one former owner, now the U.S. citizen.

[18] It is ironical that the Government of Serbia allowed the ancestors of the former royal family Karađorđević to move into the White Court residence, where the previous inhabitants were Tito and Milošević, but by making them pay a monthly rent to the city of Belgrade rather than returning them back their property. Of course, it would be unjustified to give back the property to Karađorđević family without giving the property back to the other ex-owners, too.

the ex-owners, which is far away from the market value. Except for that, further delay of the denationalization of arable land and firms negatively affects the productivity of its use.

In the first 15 months of privatization very few companies were privatized, three of them through public tenders (keeping in mind that the earlier partial privatization of the Beočin cement factory was only confirmed through this concept) and a few dozen of other companies through auctions.[19] In that light, the remark of the EBRD sounds a bit grotesque: “The most impressive achievements include highly practical and ‘deal-orientated’ privatization law … and the introduction of a foreign investment law which underlines the essentially equal status of foreign and domestic investors.”[20]

Basic reasons behind a flawed privatization law and at the same time the deficiencies of the concept could be found in the following:

1. Maladjustment of the concept with the current business environment. The concept is based on direct investments, mostly foreign, because of the low level of domestic savings and low purchasing power of domestic capital. Private investment requires high stability and a foreseeable business environment, low political and above all low economic risk, stable institutions and the guarantees of the property rights. There is no such an environment in Serbia at the moment, and more importantly, the signals that the overall condition is to improve soon are very weak. The proof that the business environment in Serbia is unfavorable for privatization as such is the low level of FDI last year.

2. Complex procedures and over-bureaucratization of the process. The procedure for auction sales (applied to small and medium enterprises) is far simpler than the one through tenders, it lasts at least several weeks (from the initiation, over the production of the prospectus of the enterprise, value estimation, public announcement, ‘till the very auction). “The Agency for privatization” represents a narrow bridge of the entire process, because as efficient as it can be, only one bureaucratic device can not complete such a

[19] The Government claims that about 350 enterprises are in privatization process, and according to its program 1000 enterprises should be sold in 2002. It is unclear how the Government would achieve that if it sold no more than 40 enterprises by September 2002.
[20] EBRD 2002, p. 10.

large task within the given deadline (privatization of around 6000 companies). The Agency is unable to respond to all those requests.

3. Non-transparency of the tender procedure. In all developed market economies the decision about the best offer at a public tender is brought according to one criterion only – the price offered by the bidders. Tender sale in Serbia presupposes the existence of four mutually incomparable criteria – the transaction price, social program, investment program and the environmental program. This method makes impossible the comparison of the bids, it is partly used to buy the social peace, and the state shows that it is still incapable to accept the social function and tries to transfer one part of its social responsibility to new owners. Incomparability of offers leaves wide discretionary power to the tender committee and opens the space for corruption.

4. Low demand of investors for domestic companies. This problem is usually quoted as the biggest obstacle to privatization based on sale, but as one can observe, in the Serbian concept there are even bigger deficiencies. From about 6000 companies which are to be privatized, according to the minister for privatization some 4000 will have to be liquidated, since they are bankrupted for longer.

The process of privatization is too slow and it is hard to expect its end within the planned deadline of four years. In an effort to enlarge the number of auction sales in July 2002, the Government - appealing for patriotism in the purchase of enterprises and using administrative measures – has invited local authorities from all 140 municipalities to turn in their lists of several local companies perceived as appropriate for privatization through auction. Instead of these illogical and uneconomic attempts the Government should undertake the following:

1. To improve the rule of law and business environment. Many important laws, which were supposed to be introduced a long time ago, are still far away from being brought into the parliamentary procedure. It is necessary to diminish the economic risks and administration in the entire economic system, which is directed towards the creation of more favorable conditions for investments. Faster reform of the banking system and the development of the capital markets are also necessary conditions for a more efficient privatization.

2. Privatization of the process of privatization. It is necessary to allow to private agencies (consultant offices, lawyers' offices, banks) to handle privatizations, and to allow firms to choose the agencies which would help them in the privatization process.

3. Denationalization. It is necessary to define as soon as possible the ownership over the companies, in other words – to create the legal basis for the redemption of ex-owners. From the aspect of privatization, it does not matter which method will be chosen, what matters is how fast the procedure would be and how quickly the legal regulation in this field would be introduced. The Government not only missed to make any positive move in this field, but it also made some completely opposite moves equivalent to nationalization – such as introducing its control over two dozen of banks, over "Mobtel", a private telecommunication company, and messing with the business of "ICN Galenika", a privately owned pharmaceutical giant.

MARKET LIBERALIZATION

Markets were to some extent more liberal during Milošević era compared to 1980-ies, but the number of restrictions and the level of government interventions on the market were very large. The government has controlled either directly or indirectly two thirds of all prices during Milošević's rule. Prices of life necessities, such as electricity, bread, utilities, were far below the market level, and that has caused frequent shortages, rationing and queues. Beside directly controlled prices, some prices were under the special regime – companies were able to change the prices but only with prior Government approval. Just a part of prices were freely defined on the market. Immediately after the loss of presidential elections in September 2000, Milošević's government started price liberalization anticipating it's soon downfall, thus wanting to inspire a larger social conflict that might be instrumental for its eventual political come-back. That plan failed and the new government continued with liberalization. Gradually price control was abolished for the most products, but some forms of control still exist even two years later. This control is regulated both by Federal law on system of social price control, and by the Serbian law on public control of prices. Some of the measures for price control are permanent (bread and milk) and others are introduced occasionally due to some special situations – one of them being, if plans defined on the federal or republic level are under question. Price control is still partially used as a tool for social care policy, especially for utilities.

Market is regulated by many laws, directives, decrees, etc. that restrict transactions to some larger extent. There are many examples of subsidizes, monopolies[21] (cartels), high levels of customs duties, hard entry possibilities, complicated procedures for doing business, unprotected contracts (thus contracting parties are pressured to enforce contracts privately). In order to approach the market economy it is necessary to continue liberalization, to enforce all voluntarily agreed contracts, to promote competition in all segments of the economy.

In agriculture, as one of the most regulated sectors, are to be abolished: 1. guaranteed prices, 2. parity system, 3. control of profit margins in trade sector, 4. direct control of basic life products. The state has to reduce the number of goods that are usually bought for state reserves. It is also needed to reduce subsidies and to open the market for agricultural products. Although "green market" is the most marketable part of agriculture, prices there are still much higher than in neighboring countries. Farmers are protected from foreign competition and some agro-industrial products are even monopolized (cartelized). Thus, some basic products in Serbia are more expensive compared not only to other transitional countries, but also to the EU. For example, sunflower oil costs 0.4 – 0.6 Euro in the EU, and 1.2 – 1.3 Euro in Serbia.

Government directly controls the price of utilities. This sector is excluded from the privatization and it is still misused for social policy. Companies in this sector are monopolists with high level of inefficiency – high prices and low level of services. As an example of the current situation in this sector "Public electricity company" employs 67,000 employees, though less than a half of this number is sufficient for normal operation. There are still no debates on the privatization of this sector and on introduction of competition in production and distribution of electricity.

Car industry with 10,000 employees produces about just a few thousands cars a year, but it is protected with custom duties of 20%. Other than important direct

[21] Since 1997 there is formally anti-monopoly law and commission, but the law is not enforced. Moreover, some new monopolies are introduced like in telecommunications, tobacco and oil business.

interventions on the market, the government has monopolized the import of oil, while drafted versions of laws on tobacco and lottery suggest similar moves.[22]

The Serbian Government demonstrates its reluctance to market solutions by adopting "decree on special terms for import, production and distribution of oil and its derivates" on March 2001, since the Government took complete monopoly on all of these operations. Oil may be imported only by the companies that have their own capacities for processing the oil (article 2) and the only company that fulfills this is the Serbian Oil Industry (NIS) that is state owned. This is not a necessary move, since the other potential importers can enter the business just if they make a contract with the only producer of the oil (NIS). This provides the space for corruption since the management of NIS can require some extra fees in order to agree with the contract. Other chance for corruption is left by the decision that Government and its commission are responsible for making decisions for overall import of oil thus looking for provisions for buying the oil at the international market.[23] The transit of crude oil is restricted to river transportation; thus the government imposes restrictions on transportation of oil by foreign companies. Oil processor can sell the oil only to the companies that are registered for trading with oil, pushing this market back to socialist system of licensing. Finally, penalties for any misuse are very high, moving between 300,000 and 3m YUD (4,840 – 48,400 USD).

Instead of overcoming problem of black market and tax evasion by encouraging the competition among importers, processors and distributors, the government decided to introduce monopoly, by promoting "entrepreneurial" function of the state, providing thus a large space for arbitration and corruption. Moreover this is wrong signal that etatism is growing instead of declining. By building the state monopoly, the government also prevents investment in the sector, thus harming its further development.

According to the draft on the Tobacco law, trading with tobacco products is monopolized by the state, and handled by the newly established Agency for Tobacco.

[22] In order to save some space, we recommend the analyzes of the previous draft version of the Lottery Law (Tasic, 2001). After public criticisms, government made new draft version of the law (it can be found on www.mfin.sr.gov.yu), for which is hardly to say that it is better than the previous one.
[23] Crude oil was never traded on the black market so the state monopoly is a reflection of some ministries intention to get bribed from foreign wholesalers.

Does this mean that in the close future we can expect establishment of Agencies for cars, spirits, carpets or chocolates?

Agency for tobacco will issue the licenses for doing business in tobacco production, wholesale and retail trade, and it will also monitor the trends on the tobacco market. Authors of this draft law claim that this will provide transparency in issuing the licenses, but it is not clear what would be the guaranties for that and what would be the penalty for failure. Agency organizes public tenders for issuing licenses for production of tobacco products "taking into account the tax priorities, market conditions and previously accepted commitments of the country in this field."[24] This implies that agency will take decisions if the budget needs more revenues from the tobacco producers and if the number of producers is sufficient. Some among declared conditions for tenders are unusual, since they require that producers: 1) have their own capacities for production of at least 2.5bn cigarettes per year – thus government knows better than producers what quantities should be produced; 2) are obliged to buy domestic brands of tobacco, at least 2000 tones per year – no matter what is the demand for domestic tobacco, or tobacco of that particular category; 3) offer the realist estimate of the fulfillment of the planed production of tobacco, specified in quality and quantity – that means that it is assumed that one may enter the tobacco market accidentally, and the government will decide weather its production is realistic.

While issuing licenses for wholesale, there are some conditions just to employ the administration, and the result is the increase in costs of doing business, restriction for competition and consequently increasing the retail prices. The license alone for doing business in wholesale costs 5m YUD for 5 years. In order to obtain it, companies are required to bring the proof that they have deposited this amount in some Yugoslav bank, or to provide bank guaranty on 30m YUD. This deposit is used for reserve and eventually for forced payment, if the company violates the contract with the state. Producers and wholesalers are also obliged to recommend retail prices. The Agency for tobacco issues permission for operation to retail sales. Retail stores are obliged to fulfill several conditions and to pay in advance 50 USD for every year in

[24] Draft version of the Tobacco Law, Ministry of Finances, www.mfin.sr.gov.yu

which they sell tobacco. Above all, they are obliged to expose at the "very visible place" the vignette symbolizing permission for trade, issued by the state.

BUSINESS ENVIRONMENT AND START UP BUSINESSES

Start up businesses are even more important for the economic success of a transition process than quick and efficient privatization. In that respect Serbia failed completely, which can be illustrated by the following data: in 2001 no more than 3000 new enterprises were established, 330 out of which were with foreign or mixed ownership, whereas in 1990 in former SFRY more than 150,000 enterprises were created, 1/3 out of which was in Serbia & Montenegro (in other words – 50,000 new enterprises in one year). FDIs were irrelevantly small – 40m USD in 2001, excluding the sales of cement-production factories.[25]

Serbia will remain a bad business environment until decisive and precise steps are made with regard to some crucial things deteriorating the business climate.

First, bad, irregular and incomplete land-register. Many buildings are not even in cadastral register, which makes both privatization and the transfer of real estate much more difficult. To foreign citizens is not allowed to buy land in Serbia and therefore they are not entitled to own even the land which they would use to build their offices and businesses: one can not own the ground planned for construction of the buildings, one can only get the right to use it. What is even worse, that right of use could not be sold to another person (if one, for example, gives up his building plans), it could only be returned to the state. It is strange that the officials in Serbia expect from someone to invest in the country where he/she is not even allowed to own a piece of ground upon which he would build his own business buildings.

Second, a complicated procedure for start ups, taxation and management. The procedure for start up businesses is desperately long, complicated and demanding. A large number of papers, documents and requests is needed (around 35 different papers and it roughly lasts 105 days)[26], which are to be submitted to the commercial court,

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[25] Their sale enlarged public revenues for additional 130m USD.
[26] »Cost of doing business in Serbia«, p. 19.

statistics and Clearing and Payment Office (ZOP), just to register an enterprise. With all that complexity the process is also very expensive, because the minimum capital needed is 5,000-10,000 USD, depending on the form of the newly-established enterprise. Except that, there are also high formal and informal costs for the speeding up of the procedure (various taxes, papers and corruption, too).[27] At the beginning of registration process one has to quote consecutively all kinds of future activities of that particular enterprise and to submit the evidence that the technical conditions for doing those activities are fulfilled. After registration, one needs to go through the process of acquiring the infrastructural connections (electricity, telephone, water supply), which can also be long lasting and very costly. Getting the telephone connection is the most simple and the quickest of all three, it only requires a few essential documents about the creation of the enterprise and about the right of ownership, i.e. use of offices for which the connections are required. The lack of sufficient number of connections, caused by the monopolistic position of the "Telekom", is the most frequently solved through corruption. Acquiring an electro-energetic connection is a lot more complicated. One needs at first an electro-energetic authorization, which means an important paper work, and then it follows a report about the fulfillment of technical conditions, which also encompasses unnecessary bureaucracy of the EPS-system. The hardest of all is, after the fulfillment of all preconditions, to actually get a connection – because of the insufficient technical capacities of the public company "Elektroprivreda Srbije". New problems arise if one erects a new building. Acquiring city-planning and building permits requires more than thirty different permits and papers from a dozen of institutions and lasts more than half a year. Another blow to business is that the judicial system in Serbia is very inefficient and slow. The processes are lengthy, efficiency is low and the level of corruption is very high. On the top of all that, one ought to add the fact that, because of the system which protects the debtor instead of the creditor, a lot of credits are paid through the judicial enforcements, which additionally slows down the business cycles of enterprises.

[27] According to the research of G17 Institute »Cost of doing business in Serbia«, p. 20, those costs go up to 4,000 USD and the procedure of starting up a business lasts from 16 to 71 day; 16 days are needed if one bribes the state employees and 71 days are needed if there's no bribe. That is an average time calculated after 5% of extreme cases were discarded (i.e. 5% of the fastest and the slowest).

A big problem arises if an enterprise wants to change the branch, or to widen its scope of business activities. The procedure encompasses a new collection of evidences about technical equipment, preregistration at the court and the statistics and acquisition of codes for new activities.

Third, there is still no bankruptcy law in Serbia, but only a law on insolvency. In practice, that means one could get credits, liquidate the enterprise and open another one anew, without paying back the earlier credits.

Fourth, the commercial law is restrictive and bad,[28] a new one is still to be introduced and in that sense nothing was done so far. Auditors' reports are nor reliable at all and nobody in Serbia takes them seriously; it is widely believed that a desirable auditing report is easy to get against money compensation.

Fifth, regulation of the businesses is large and constantly changing. As the reform of the system of public administration is the lengthiest and hardest part of the transition process, it is deemed suitable to accept the institution of "silent administration"[29], as it was done in some of the neighboring countries (Croatia, Hungary). That means, if the administration does not respond within the envisaged deadline (which has to be a lot shorter than the present 60 days – in Croatia it is 22 papers and 14 days of deadline), one presupposes that the enterprise has received a registration permit. It is worth mentioning that the procedure of enterprise registration in Canada, whose economy is not among the most liberal ones, lasts up to two days and costs 280 Canadian dollars.[30]

Sixth, discouraging macroeconomic environment. The ***exchange rate*** of dinar is relatively stable, dinar is informally tied to the Euro, and the question is for how long this relative stability will last. ***Inflation*** is now lower than before 2001, but it is still high and too unpredictable for normal monetary standards[31]. High economic risks require ***high***

[28] Existing commercial law is based on completely wrong principles – granting privileges to 1) debtors over creditors, 2) state owned over private sector, 3) domestic over foreign businessmen, 4) employees over owners.
[29] »Silent administration« in Serbia does exist in the case when one needs a connection to the electricity system, but it has a completely inverse meaning: the lack of response means the refusal rather than acceptance.
[30] S. Djankov, R. De La Porta, F. Lopez de Salinas, A. Shleifer, »The regulation of entry«, Third Draft, June 2001.
[31] The officials of the NBY and the Serbian Government at the end of 2001 predicted the rate of inflation of up to 25% for the entire 2002. After the publication of statistical data on the rate of inflation in January and February 2002 the officials said that the inflation in 2002 would be up to 15%, and in June 2002 the

interest rates, which additionally discourage new investments (interest rate on the credits denominated in Euro is between 1.5 and 2.5% a month and 9-15% a year). It is worth mentioning that there is almost no bank ready to give credits denominated in dinars without the foreign-exchange clause, which tells enough about a very low level of confidence in domestic currency. The existence of ***monopolistic state structures*** (oil, tobacco) is a very important psychological momentum above all, because it is a clear signal to potential investors that the state is ready to do anything in order to enlarge its budget.

Seventh, enormous taxes and high level of state expenditures (see the part of this study on taxation).

Eight, the market of Serbia is small and undeveloped, so one can not expect that foreign companies would enter it just because they count on the future potential of the market, as they would do in Poland or Ukraine, nor one may expect that the market would be sufficiently liberalized soon to enable doing business in a normal way.

Ninth, apart from economic risks, political and security risks are quite big, too. All of the previously mentioned items enlarge the risks for doing business, and the bigger the risk, the higher the price of money. That way, the credits become too expensive for most of the average profitable businesses, so that the total number of transactions is relatively small, but the interest rates can not be lower until the risks diminish, too.

Even before the change of the regime took place in Serbia, it was evident that the business environment is very bad, which was documented by many short elaborates and opinions of experts and especially emphasized by the study "Cost of doing business in Serbia" in early 2002. Only after that, when everything was more than clear, the governments of Serbia and the FRY came up with their claims that there obviously exist numerous obstacles for doing business, which are to be investigated. Therefore, the Ministry for international economic relations of the Government of Serbia made a study in June 2002 about the business environment and stated the well known fact – that it is

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officials of the NBY prognosed the yearly rate of inflation of up to 9%. After the price of electricity increased in July 2002 and the rate of inflation suddenly went upwards, the officials are now predicting the rate of inflation of around 15%, while Miroljub Labus, deputy prime-minister of the FRY predicts the rate of around 20%. *Labus: Yugoslavia in the EU maybe by 2010*, **Danas**, July 16, 2002.

bad. To realize where those problems are one does not need to spend 18 months in power[32] and to conduct additional studies.

Instead of doing the only thing a state should do in a market economy – establishing the rule of law and solid rules of the game – the Government of Serbia did everything else but that. That government did not got the message that the prosperity cannot be achieved by political means, so it has tried to use exactly the political means to achieve something, not even realizing that by doing that it only prolongs the practice of socialism.[33]

For example, immediately after seizing power the Government has organized the meetings with foreign businessmen, invited for several times the ethnic Serbs successfully working and living abroad, and organized the meetings with the chambers of commerce of certain countries (Italy, Germany, Austria, USA). Government representatives traveled into large multinationals (Siemens, Microsoft) or brought them to Belgrade, organized the associations of foreign investors[34] in Belgrade and did many other unnecessary things with only one purpose – to attract foreign investments to Serbia. According to the newspapers' reports a "Business council of the Diaspora" was formed in Belgrade on June 21, 2002, and in late July a six-bank consortium was formed with a fund of 60m Euro dedicated to credit domestic entrepreneurs willing to buy small and medium enterprises (if they would really want to buy them, they would have done that already by now).[35] Of course, the result of all those moves of the Government is equal to

[32] Some ministries in the Serbian Government have not noticed until June 2002 – after one year and a half spent in power – that there were serious obstacles for doing business in Serbia. Some problems among those quoted here were identified and the question is what the government will do now to resolve them. Before the Government of Serbia, the G17 Institute made a study »Cost of doing business in Serbia« in the spring of 2002 in which the existing conditions were identified, but no solutions were proposed, so another research of the ministries of the Serbian Government was not necessary.

[33] Therefore, Dimitrije Boarov, a well-known journalist, rightly said for the members of the Government that "they say they were educated in the West, but they think and work as if they have just arrived from Moscow".

[34] Initiation of the »Council of foreign investors« in mid-July 2002 was nothing but another desperate move of the Government of Serbia. The Council is supposed to investigate what prevents foreign investments in Serbia, as if that is not widely known already. The Council members are: British American Tobacco, Bull Yugoslavia, Holcim, HVB Yugoslavia, Hyatt Regency, Mercedes Benz, OMV, Price Waterhouse & Coopers, Siemens, Societe Generale, Tehnogas, Tetra Pak and Velux.

[35] The consortium members are AIK, Vojvodjanska bank, Delta Raiffeisen, HVB Bank and Jugobanka. Foreign companies are often forced to support this kind of Government moves in order to survive at the market. The funds given for this purpose can be treated as an informal tax. Refusal of these initiatives would lead to the use of Government discretionary powers against such companies, which would be a lot more expensive for the companies.

zero, because (foreign) investors do not come when the Government invites them or when not even the domestic investors are willing to invest, but when the conditions for investing and doing business in an environment are favorable. The situation can be well illustrated by a statement of one Austrian banker, operating in Belgrade: "I am in constant touch with the German companies willing to invest here, but when I explain them what's the real situation like, they always say they would like to wait for another year."[36]

LABOR MARKET

Market reforms are impossible without the reform of the labor market. The aims which are to be achieved are the following: creation of the preconditions for wages and labor adjustment, induction of the labor demand which is the only way to decrease the existing mass-uneployment, improval of the efficiency in the use of this resource in order to increase the overall economic efficiency. Flexibility of the labor market requires a simplification of the hiring and firing process, or in other words – the creation of such formal preconditions which would enable the entrepreneurs to adjust the level of employment according to the entrepreneurial calculation without a large cost. Solutions offered by the Labor law[35] go along this way. The employment procedure is simplified in comparison to the earlier practice. There is no legal obligation to perform the employment through the public ads, which used to prolong and raise the price of the procedure. It is envisaged that only the general conditions of employment are determined by the law, and that all other conditions needed for the specific job are determined by the employer (all types of flexible employment known in developed economies are available, too). The firing process is also simplified. The law quotes the justified and unjustified reasons for firing (article 101). Unjustified reasons are quoted in order to prevent the discrimination of workers (according to gender, religion, race, etc.). Justified reasons are those which come from the non-fulfillment of some of the elements of the contract by the

[36] Klaus Miler, the director of Micro Finance Bank in Belgrade, for **The Wall Street Journal**.
[36] Official journal of the Republic of Serbia, December 13, 2001.

employee or from the fact that the need for a certain job ceases to exist due to some technological, economic or organizational reasons. This reason is actually based on the market dynamics and uncertainty, and it represents the main criterion for firing the redundant labor force. Apart from that, the level of forwarding charges paid by the employer to the fired employee has been diminished, so the firing costs have been decreased in comparison to the previous legal solutions.

Another aspect of the flexibility is the adjustment of the wage level. The wage flexibility is now in the hands of collective bargaining. Unlike the previous system, the Law only provides the framework for a collective contract, and specific regulation of the questions in collective contracts is left to unions and employers. Leaving a possibility for the responsible minister to decide ("if these is a justified interest") whether the collective contract or its specific parts are applied or not upon those employers who did not participate in the determination of the collective contract (art. 149) is not good. This possibility does ultimately exist in European countries, too. Still, we do not see the need in Serbia to apply this kind of unification. On the contrary – it is necessary to free enterprises and workers representatives to adjust the employment contracts to specific conditions and their own preferences.

The law allows to the participants of the bargaining process (Serbia's government, representative association of the employers and the representative union) to freely determine the minimun wage. If the agreement is not reached within 10 days, the Government autonomously makes the decision on the level of the minimum wage for the period of minimum six months. The wage is determined according to the working hour for the full working time. The employee has the right to the minimum wage only if he has worked a full working time and accomplished a standard efficiency. That way the minimum wage is related to the exact efficiency performed. Minimum wage does not protect all workers (if it is higher than the market wage, it only increases the unemployment), but it guarantees to state the minimal level of revenues coming from the income tax, because private employers, in order to avoid the state plunder, claim that they do pay their workers minimal wages, and in cash they subsidize them with the money undeclared in their enterprises' balances of payment.

What are the results in practice? No significant changes are felt yet. Serbia without Kosovo has 7,497,437 citizens in 2002, some 69,500 less than on the census from 1991. The ratio of employed to total population is low and it is on decline. Total employment in Serbia in August 2001 and in May 2002 was 1,550,886 and 1,476,468 respectively.[38] Total employment from March 2001 to March 2002 is down 5.3%. The official unemployment rate (without workers on «forced leave») for 1998, 1999, 2000, 2001 and 2002 amounts in 25.1%, 26.5%, 27.3%, 27.8% and 29% respectively. Total number of officially unemployed persons moves around 850,000, and it is higher in 2002 compared to 2001 for some 5%. In addition, nearly one million is employed in *de facto* bankrupted firms. Unofficial unemployment rate is estimated to some 50%, and it reflects the real situation on labor market. In order to survive, the majority of unemployed working force operates on the black market.

The dichotomy of the formal and informal ("grey") market is still sharp.[37] Formal labor market is characterized by: a low level of working engagement of the population, low labor force mobility, mass open and hidden unemployment (up to 80% of the unemployed has to look for a job for longer than 1 year), high participation of the youth in overall unemployed population, low wage level, high disparity of the wages among the employed people of equal or similar qualifications. It is estimated that at least 1 million people are engaged in the grey economy. High participation of the grey market is not a surprise, as many private enterprises function in this zone of the economy. High participation of the grey market shows that something is wrong with the existing system of rules. Unchanged condition of the labor market is the consequence of the fact that the processes of the creation of new enterprises and of the privatization are slow, so that a smaller number of new jobs is created and the managers are not induced to adjust the level and the structure of employment. They have no motive to behave as entrepreneurs. On the other hand, one should not forget that the Labor law represents just the first step in the reform of the labor market institutions. Many laws that should support this law are to be changed. In other words, the reform of the labor market is still at its very beginning. Because of that, current bad results are not a big surprise.

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[38] **Ekonomist magazin**, no. 120, September 9, 2002, p. 65. The figure covers firms in state (public) ownership, social cooperatives and mixed ownership. Private firms employ additional 580,000 people.

[37] For a detailed insight into the condition of the labor market in Serbia, see: Krstić & Stojanović, 2001.

In the last few months, the unions come up with new demands more and more often, trying to back up those demands with the threat of a general strike. The Government has different responses to those demands: sometimes it accepted demands, and sometimes it doesn't. Its activities are determined according to how capable a specific union is to exercise a social and political pressure. Coming up with some demagogical demands for redistribution according to the strength of the pressure is wrong, because the point of the transition is on allocative rather then on distributive dimension. In comparison to the other reform moves of the new authorities, the Labor law is one of the better ones, because it fits better to the practice of the developed economies. Still, there is a possibility for a further rapprochement of the labor market regulation to the free market principles, especially to the key points of the law, such as hiring and firing, minimum wage and collective bargaining.

MONETARY POLICY

Monetary policy has often been pointed out as one of the major achievements of the reforms in Serbia. For example, EBRD states: "The strict monetary policy of the National Bank of Yugoslavia (NBY) has led to lower inflation, a sharp rise in foreign currency reserves and stable exchange rate."[39] However, the truth is that it has been continued with policy – similar to that in other spheres. Some cosmetic changes have been done, new chiefs of NBY have been elected, but rules of the game were not changed significantly. New monetary policy-makers suppose they know better then market what is real exchange rate for dinar (YUD), should people save in domestic or foreign banks, how many *bureau de change* should be and where it should be located, how many banks is needed, what is the amount of foreign currency citizens can take with them on the trip abroad, should transactions be carried out in dinars or foreign currencies, and so on.

Yet in October 2000, when it had to be determined whether to a) adopt bi-currency system, b) abandon national currency, c) implement currency board regime or d) continue with old practices – a wrong decision is made. There was no need for "serious

[39] Cf. EBRD (2002), p. 4.

econometric analyses" to conclude that confidence in domestic currency is low, inflation expectations are high and ingrained, and accordingly the currency will be more stable if the space for monetary policy is smaller. Otherwise, more "monetary policy" leads to less credible currency. Having euro or dollar as a competitor to dinar would have been excellent mechanism for subduing domestic monetary policy-makers, but it was waived from the very beginning.

However, arguments for making the NBY "the most profitable legal person" in Serbia prevailed. In September 2000, M_1 and M_2 were 23bn and 29bn dinars, respectively. Due to money velocity decelerating,[40] these aggregates could increase to 89bn and 98bn dinars[41] respectively, without causing inflation that would be attributed to money supply accretion.[42] On 21st August 2002, monetary stock M_2 has already reached 102bn dinars, and the Governor put into circulation new 5.000 dinars (80 USD) bill, but refused to say what is the issue of the denomination.[43] It was actually seventh new bill issued since October 2000.

The program of maximizing of seigniorage while not causing "too high inflation" has played an important role in rejecting dollarization or bi-currency system.[44] The practice of giving credits to bankrupted firms at non-market criteria[45] has been continued (although to a lesser degree) rather than abandoned. Opportunity cost of losing "creative monetary policy " is reduction of incentives for real sector reforms.[46]

Bad primordial choice has been followed by other old practices, and so the modest results of the NBY in dinar's stabilization are not surprising:

▪ Inflation is reduced, but not stopped. In 2001, anticipated inflation was approximately 30%, while real inflation rate, measured by increase of consumer prices, was 38.7%. In 2002, it is expected its further fall bellow 20%. Nevertheless it is

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[40] That was a consequence of extremely high inflation expectation decreasing after old government change.
[41] Preliminary data for June 1, 2002.
[42] For example, for 2001, NBY anticipated approximately 30% inflation rate. Some 15pp would be the consequence of price liberalization and almost 15pp the core inflation – a category miles away from disparity elimination.
[43] Reports from press conferences, published August 22, 2002 in daily newspapers "Blic" and "Danas".
[44] Currency competition is better solution.
[45] Unfortunately, every time and everywhere, any money invested by state is a wasted money. Money invested by NBY was used for "reforms delay" and creating impression that there are "reforms without reform measures taking" and "living standard improvement without productivity increase."
[46] Although "reformists" would probably find some other borrowing source.

worthwhile mentioning that inflation during first seven months in 2002 has been 8,8%, what may mean a 14-22% annual rate. Much higher inflation rate was in period September 2000-September 2001, but that was due to freeing prices and correction of price disparities, i.e. one of the very few good things done by ex-regime wishing to cause social-economic problems to new authorities by liberalizing prices. The existence of notable core inflation suggests that dinar is not a good solution, because the level of inflation expectations is rather high.

- Besides being high, inflation is also unpredictable, what is considered as a significant problem in economics.
- NBY claims that exchange rate is "fairly stable" and dinar has lost only some 6% of value compared to euro in the period October 2000 - September 2002. This is a huge delusion supported by the facts that there is no freedom of money and capital movement, and that dinar was considerably undervalued during previous regime[47]. Current exchange rate is preserved by administrative measures (mentioned at the beginning of this section) and it has become a mean of political promotion a long time ago.
- NBY has also declared external convertibility of dinar, supported by the IMF. However, the only measure of convertibility is the market, whose *vote* is utterly different from that of NBY and IMF, since there is almost no commercial bank in the world ready to buy dinars.[48] This time, the major culprit is the real sector that does not have adequately attractive export products to increase consequently the demand for dinars abroad.
- The difference between interest rate on dinars and interest rate on foreign currencies is an obvious indicator of domestic currency quality. While interest rates on foreign currencies are expressed in annual, interest on dinars is expressed in monthly amounts.[49]

Administrative means are also used in commercial banking regulation:

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[47] Due to extremely high inflation anticipation and destroyed national economy, foreign currency demand was very inelastic and caused dinar undervaluation.
[48] Even, foreign banks that have branch offices in Belgrade do not offer dinar outside Serbia.
[49] For example, Delta Bank's annual interest rate for euro is 4,8%, but monthly interest rate for dinar is 2%.

▪ A phantom institution – NBY's Clearing and Payments Department (ZOP), which has changed its name several times during last decade – still exists.[50] ZOP is a type of monetary police and during this year, one of its parts has been named *Nacionalna Štedionica* (National Savings Institution, NSI) and become another state-owned commercial bank. Special paradox happened at opening of the NSI: just some ten days before, four largest state banks were shut down, and some of owners/founders of this newly opened bank are largest debtors of these four banks, such as "C-market". ZOP still performs payment operations in Serbia instead of transferring it to commercial banks. NBY announces that payment operations will be transferred to commercial banks from January 1, 2003, although similar announcements in the past turned out to be a lip service.

▪ Moreover, in accordance with non-realistic estimations was also the NBY's decision to ban greenfield foreign banks entrances after couple of months, and to condition the entrance with buying some of domestic banks. It has been decided that only five foreign banks[51] can enter on the Serbian market wherewith NBY showed its non-market determination.

▪ To foreign banks is imposed an obligation to invest in Serbia 50% (class A) and 75% (class B) of collected deposits. If they do not so, non-invested amount up to 50% or 75% must be deposited on special account at NBY.[52]

Thus, an increase of savings and foreign currency reserves is not surprising:

▪ In spring 2002, foreign currency savings grew up to 651m euro, while dinar savings were just approximately 40m euro. In mid-2002, the trend of savings has been stagnant and deposits short-termed. Increase of saving in the beginning of 2002 was primarily due to privilege to convert national currencies of "Euroland" countries into euro via short-term savings without paying the conversion fee. The data translated into relative indicators are even more disappointing: just 15% of disposable foreign currencies are on citizens' savings accounts. NSB pays annual interest rate (for foreign currencies) of 1.5-2.5% on three-year deposits, what is lower than inflation rate in euro and USD zone

[50] Nowadays known as NBY's Clearing and Payments Department (ZOP).
[51] Very soon foreign banks held 35% of total deposits in Serbian banking sector, although 60% of that saving was caused by conversion in Euro and escaping conversion fee. Cf. EBRD 2002.
[52] NBY then invests these resources, without giving any accounting to the banks whose money it is where those funds go and under what terms they have been invested.

in 2002. Moreover, the same bank pays interest rate of 25% on dinars, yet savings in foreign currencies is 13 times larger than savings in dinars.[53]

- National foreign currency reserves have significantly increased and reached the level of approximately 2.7bn USD, but the problem is that in commercial banks is to be found around 870m USD only. Important source of the foreign currency reserves is compulsory conversion[54] of all donations and loans into dinars, as well as obligatory foreign currency reserves imposed to the banks.
- On June 2002, dinar has been declared as the only legal tender of payment (except for some minor exceptions, such as residences buying, rent paying), and payments in foreign currencies are put out of the law. Such decision is not reasonable in the country where 4/5 of money supply consists in foreign currencies, so the majority of citizens is in danger to become criminals. The latest decisions, which should perpetuate 'patriotism' in monetary sphere and induce citizens to use dinars as much as possible, emphasize that building trust in dinar does not go as planned, and it would be a pity not to broaden the use of dinars in capital transactions (smaller ones), since there is huge potential for further penetration of domestic money.[55] The only problem is that citizens in Serbia do not believe in high quality of domestic currency, but there are newly imposed Draconian fines for changing the perception.[56]
- During 2001, real discount rate was mostly negative and on annual and monthly level it was respectively: in March 1.3% and 0.1%; in June –29.86% and –1.8%; in September –1.41% and –0.1%; in December –6.94% and 0.95%. The same practice continued in April 2002 (-0.52% and –0.04%). This implicitly means it can be counted

[53] M. Kovačević, 2002, p. 7.

[54] According to order issued by the Serbian Ministry of Finance and NBY, commercial banks are obliged to immediately convert donations and grants (regardless whether they are awarded to state, municipality, organization or NGO) into dinars at current exchange rate. Donation or grant user receives dinars, and foreign currency becomes a part of foreign currency reserves. Therefore, NBY and Serbian Ministry of Finance force commercial banks to violate contracts with their clients (contracts clearly point out that money in banking account have to be in foreign currency, no way in dinars) and force them to bear dinar depreciation risk, although dinar lost 6% of its value compared with euro.

[55] In the beginning of this year, Serbian citizens converted over 8bn DM into euro and other currencies, and certainly they had significant amount of USD and CHF.

[56] Trying to continue with previous politics of enforcing the use of domestic currency, NBY has imposed Draconian fines for use of foreign currency. Fines for physical persons are between 200 and 21,000 dinars (3-339 USD), and for legal persons between 4.200 and 630,000 dinars (68-10,000 USD). These laws are Draconian in country with average monthly wage of 150 USD.

on socialization of poor investment decisions[57] or monetary policy measures can neutralize weaknesses of the real sector.

- Central bank continued with its 'successful operations', especially by engaging in philanthropic activities (e.g. scholarships to students and improving health care in Serbia), resolving problems of unemployment (continuing to enlarge its bureaucratic apparatus and wasting money on employing totally useless employees such as hostesses in NBY headquarter). It turned out that NBY is also a loss-making institution, although central banks usually gain seigniorage. In 2001, the NBY suffered a loss of 8.25bn dinars,[58] and the Governor submitted its report on June 28, 2002, instead on March 31 – the date of legal obligation for report. "Remaining value of NBY capital is just 1.2% of its total assets. Hence, the central bank is significantly undercapitalized. NBY liabilities are 84 times larger then its capital."[59]

However, it would be wrong to impute all omissions to NBY and its Governor, since the responsibility for lack of financial market and lagged reforms in banking sector rests, to the great extent, on ruling coalition that does not carry out reforms in real sector. It is limited space to perform reforms of the banking sector, without comprehensive economic reforms.

Dinar cannot be stable and monetary policy credible, if national currency stays under a greenhouse established by "administrative measures". Currency competition would be excellent step toward reestablishing confidence in domestic currency, and monetary policy-makers would be restrained for "creative innovations".

Reforms in monetary sphere are far away from being satisfactory, especially having in mind: the use of administrative violence; the NBY's bureaucratic paternalism; competition inhibition; banks exposition to restrictive measures; high and unpredictable inflation; quasi-stable exchange rate preserved by force, and foreign currency reserves increase as consequence of administrative violence.

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[57] Foreign banks do not want to participate in socialization, so MFB approved only 1800 credits with total amounts of only 12m euro, till April 2002. Up. EBRD 2002, p. 8.

[58] Cf. M. Kovačević 2002, p. 7. Losses originated from writing off 9bn dinars of domestic banks' debt to NBY. NBY also wrote off debts to some state-owned firms that make profits (JAT, some banks). Institute for Manufacturing Banknotes and Coins (it is not privatized), NBY Clearing and Payments Department (it has monopoly and collecting provision for all giro transactions) and Military Service are integral parts of the NBY.

 M. Kovačević, 2002, p. 7.

BANKING SECTOR

While strictly following the policy of nourishment of the old system with new people, the new authorities have managed to do next to nothing in two years for creation of a banking sector similar to countries which have adopted and implemented the basic principles of a market economy. Hairstyling of the shattered banking left the system that brought it to ruins practically intact.

Structural changes were the most apparent ones, at the same time being the only "bright stars" of reforms. The officials started cleansing of the sector by revoking licenses and starting with liquidation and bankruptcy proceedings.[60] The change in legislation has doubled the capital census requirement of banks, forcing the smaller institutions into a series of unreasonable and involuntary mergers.[61] Licenses were revoked in some hopeless cases, which is good, yet questionable are the effects of the policy to give many banks "time to adjust". While not all-encompassing, the cleansing was arbitrary and indecisive; by being so, it was under a significant influence of interest groups, and there is a notable lack of political will to complete it. Out of some fifty commercial banks existing at year-end 2001, only five had posted profits. The surviving domestic banking system, as a whole, still has deeply negative equity (i.e. the banks' aggregate liabilities are greater than the aggregate assets).

The State is the main owner and, at the same time, creditor of the banking system. Growing State ownership clearly manifests the intention to prolong the State's utilization, control of, and benefit from commercial banking. Apart from having most of controlling stakes[62], the State, through *nationalization of debtor banks*, increases its majority

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[60] Some 23 de-licensings were applied, which halved total industry assets from 10.8bn to 4.7bn euro, not including 1.5bn euro in the still existing state claims from banks in liquidation. This data is taken from press, and are not reliable due to frequent changes and disputes between the NBY and Banks' Association and other sides. Licenses were revoked from those banks ruined by the former system, and most of it relates to the 4 largest banks, carrying 5.5bn euro in assets (50% of sector assets), and 5.1bn euro in loans (of which 97% is classified as non-performing loans). Some 115m euro should be collectable. Fixed assets of all liquidated banks amount to 110m euro. Potentially, some extra 100m euro of frozen deposits in New York and Cyprus may be added to the liquidation value, making the total of approximately 325m euro.

[61] Some 11 mergers & acquisitions were forced, involving 29 small institutions in run from the progressively rising capital census. From 5m USD, capital census rises to 10m USD by late 2003. More mergers and acquisitions are expected in the future.

[62] Even with the minority stake, the State usually manages to keep full control, due to large diversification of individual shareholders, and low level of corporatization, in general.

ownership to a total of eleven banks, and minority stakes to seven more, holding the incredible 50-60% of total industry assets.[63] Nationalization is performed under a "later privatization" motto, which is a tough pill to swallow.[64] Similarly to that there is not enough political will to shut down weak or nearly-bankrupted banks, there is no political will to abandon the State's active participation (ownership) in the sector. Stalling of privatization prolongs loss-making, wasting time and whatever productive assets that remain, while depositors and partners are being exposed to risks they are not aware of. The State has, through the policy of an informal tax imposed on few existing successful corporates, founded even another new majority state-owned bank- the National Savings Institution (NSI), towards which business is directed through power of State discretion and arbitration. Top Serbian officials and the NBY Governor, through promotion of their newborn, abuse public posts and institutions they represent: besides regular representation of NSI, they, in a ritual manner and in front of national TV cameras, open private accounts with NSI, giving an example for others to follow. Of course, NSI deposits are booming comparatively afterwards.[65] There is no intention to discard the nationalist and populist ideas of strong domestic (even State-owned) financial institutions.

[63] Because of informal privatization, banks are currently owned by a diversified pool of private and state-owned companies, and the state of management is chaotic. Therefore the State has a notion of active control in much more than 50-60 % of the banking sector assets, majority owned. A total of 18 banks were forced to issue new shares to convert Paris and London clubs' debts into State equity.

[64] Property rights of the current shareholders are being severely violated, because the State increases its stake in the sector, on their account. The State got a massive bailout for a large part of debts from international creditors, and it should have applied relative write-offs to all debtor banks that would then be in position to clean their own balance sheets by off-writing their debts to final, SOE debtors, thus clearing a mass of balance sheets in the economy. The state has chosen to hold on to these "claims" and to significantly increase its ownership and control in the banking sector, and later from final SOE debtors, through privatization. Such massive - scale etatization does not guarantee that the State shall successfully privatize these banks (as mentioned, to be sold to strategic partner) - to the contrary. Banks wishing to acquire a domestic bank and thus pay for the entry ticket, are looking to find considerably smaller and more viable partners. Etatization clears to an extent, by force, the ownership structure of banks before privatization, yet not enough to erase an additional obstacle of the highly diversified and chaotic, but private, ownership. Most likely, the State's intention to sell out these banks will end-up in one of the three manners: i. Allowing again free entry, as a result of incapability to find a buyer (expensive entry ticket), ii. Selling the banks for peanuts value, or iii. Forcing of domestic corporates to purchase shares in banks, which is the least likely an option. In any of the cases, banks with no going concern will be shut down. In short, stakes in these banks remain property of the State in a longer run, while their agony is prolonged.

[65] Though minimal, taken into account that the majority of cash in economy still remains off- balance and off-shore, which truly represents a real (market) test of success of the monetary policy, trust in banking, currency and the State, as judged by population and corporates.

There seems to be no necessity to enhance the objective (non-State) insight into "who is who" in the financial sector. Although many banks still do not fulfill the basic prudency criteria, NBY considers them equally dear and sound, and categorizes them all together in the same "A+B" basket of banks. On the other hand, NBY financials and operations are kept far from the professional and public scrutiny. NBY's newly established Central Credit Register Information charges extraordinary fees for its low quality services, while having monopoly over such information and activity. The nourished *lack of transparency* is likely to create more chaos once payments in domestic currency are (eventually) transferred from the socialist-era payments bureau (NBY-ZOP) to commercial banks.

The State prolongs the practice of *intense arbitration in commercial banking,* while doing nearly nothing for creation of an institutional framework that would foster fair competition and banking on commercial, and not on political basis, as in the eighties and nineties. The authorities still to a significant extent govern the decision-making of most bank managers: while still operating in little or plenty collision with prudential criteria, banks are in constant fear of punitive measures. Banks are also are in fear of other, arbitrary punitive measures by the NBY and the state in general, such as those based on the"Extra-Profit Tax Law" and other.[66] Administrative violence[67] creates an atmosphere of fear and obedience, while banks carefully earmark the slightest signals coming from the NBY and State authorities. The State enjoys the *status quo* as it provides for high amount of control and power over the sector, and through banking over the corporate sector as well. Of course, there are rewards for the obedience- big business always involves the State as intermediary, while the State often has decisive influence on choosing of a banker between the partners involved. Along with the increments of influence and arbitration[68] of the State, as active owner and manager of banks, other, informal ties are created. More time and energy is spent on assuring the public of soundness of individual banks and the banking system, as with the success of reforms,

[66] Media statements of the Governor often have serious consequences on operations of commercial banks.
[67] As described here and in part on Monetary Policy, regulation of commercial banking
[68] A good example would be the one when the governor Dinkić gave to the press his assured beliefs on that Komercijalna bank would overcome foreign (start-up) Raiffeisen bank, in terms of the collected new foreign currency deposits, while the headline in the "Telegraf" was "Komercijalna shall roar past Raiffeisen". It soon happened, needless to say, and the Governor was right.

than actually changing anything. Such impact of State influence is additionally supported by the lack of transparency in the sector. As one of the consequences, there is a high influence of such advertising on choices such as where to maintain accounts, deposit funds, and who to bank with in general. Since there are still no serious risk management and pricing functions in domestic banking, Komercijalna bank and similar large banks are able to eliminate the risk factor from their pricing, thus offering significantly higher interest rates on deposits[69]. Together with advertising from the side of the State, this is the main factor of the relative, short-term success of domestic banks in comparison to newly- founded foreign banks' subsidiaries. On the other hand, and as a price to pay, domestic banks, strengthened in such a manner (under the infusion of new savings), are made into corner-stones of financing of the pre-privatizational reconstruction of the State-owned economy, and are building rather shaky loan portfolios. The State influence is so great and inconsiderate, that the State even presumes to offer and promise financing on behalf of some banks[70]. The state puts an enormously strong pressure on banks to inject money in the economy, attempting to jump-start the economy, disregarding the fact that opportunities are truly scarce in reality[71]. Domestic banks simply follow this, while foreign banks successfully withstand the pressures. Whereas there is no possibility to price and charge *these* commercial risks taken on the State and Socially-owned enterprises (SOE), nor for the deals where the State appears as a guarantor, domestic commercial banks are gambling not only with their own newly attained solvency and capital base, but also with newly attracted savings[72]. High reliance on state budget liquidity, and vast placements of the same in the state and "social" (quasi-state) corporate

[69] For interest rates, see a part of this study on monetary policy.
[70] An example is when Z. Đinđić tried to "soothe" the syndicate of berry-like fruit producers who demanded greater price protection from the State, by offering credit for the purchase of crops from farmers (mostly from Komercijalna bank)
[71] This may be seen from the fact that the foreign banks, having the experience and know-how in risk evaluation of potential borrowers, experience great difficulties in finding creditworthy applicants (mostly short term working capital financing of the established players, with some low scale 2-year max investment financing of the same, and truly exceptionally the mid and long-term financing of the country's blue chips. All lending activities are collateralized.
[72] State and "socially" (quasi-state) Owned Enterprises (SOE), are last traceable points of losses in the economy. Although for many the going concern is weak, while value and marketability are next to none, these very same SOEs mainly exist untouched by the bankruptcy and liquidation proceedings. Instead, hazardous materials that already shattered the banking sector, are now supported by the State which obviously still considers them a part of the system. Unfortunately, these enterprises still actively participate and, due to size and support they get from state and quasi-state banks, strongly influence the financial market by distorting reality (interest rates).

sector, can also lead to solvency problems of largest domestic banks (VB, Komercijalna bank, AIK bank, Delta bank). There seems to be no end to the State's preferential treatment of domestic banks, and suggestions for aggressive lending policies despite existing limitations; Such dangerously one-sided State interventionism has ruined the system before 2000, and there is no reason to assume that this time it will be different.

Only five "domestic banks with foreign capital"[73] were allowed to enter "green field", since October 2000. After that, governor Dinkić set his stance on market economy by downing the curtain for free entry, deciding that there was enough foreign competition on the market. Foreign banks now wishing to enter the market, are informally taxed by purchasing one of the domestic banks, which proved to be simply too high cost for a more significant FDI in the banking sector. Even the foreign banks are informally taxed for their activity: the State makes them see the world without any system risks, and to take huge risks on the NBY - banks are forced to keep 50% of their collected and un-placed foreign currency savings on their quasi-provision accounts of the NBY quasi-reserves system.[74] Not only are the banks taxed informally and forced to take State risk this way, but also are depositors whose deposits are half-way "taken care of" by the NBY, who also keeps a percentage of their interest. Apart to this humiliation, image and reputation of foreign banks are widely "borrowed" by the State who uses their presence to captivate public belief in strength and health of the banking sector in general. Even they are occasionally forced to sign various PR protocols on future lending activities in line with the wishful thinking nourished by the State officials.

The short-term economic policy of creating stability now becomes a long-term political goal of stalling with the *status quo* and delaying the reforms. As in other areas, there is no real intent for an all-encompassing reform. The lack of healthy regulation is still an acute problem, while the system still protects the borrower instead of the lender. Strong state presence, control and arbitration, are still fervent and popular measures-privileges, at one side, and state coercion at the other, remain the dominant criteria of the business environment in banking but also in the real sector.

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[73] Hereafter referred to as "the foreign banks" - Reiffeisen banking group, Micro Finance Bank (EBRD, FMO, IMI, Commerzbank), HVB group (Hypovereinsbank & Bank of Austria), Alfa bank, all joined Societe Generale, who opened a subsidiary in Belgrade early in 1991.

[74] Funds which NBY (though not admittedly) most likely places abroad for their own account, and against which local currency economy is re-monetized (dinars are issued against this backing)

SECURITIES MARKET

Serbian securities market could be divided into several segments: bills of NBY, commercial papers and short term bonds of companies, old frozen foreign currency savings bonds (FX bonds) and equities.

Because the Treasury is established just few months ago, there are no T-bills in Serbia. Instead of that, NBY is issuing its own securities to conduct monetary policy. Primary sale is on the Belgrade Stock Exchange, what is very rare in the world, but the government is trying to find a job for the stock exchange which is under great influence of the same government. The method of primary auction is so called 'quantity auction'. The price (or the interest rate) is determined by the government rather than on the market, and buyers are biding just for the quantity. Only banks and other financial institutions can bid at the auction. Maturities, interest rates and quantities from the auction on August 30, 2002 are shown in the table:

Maturity (Days)	Interest rate (p/a)	Volume (Mn YUM)
30	10.50%	1,200
60	11.50%	120
90	14.00%	87
180	15.00%	0

What could be easily seen is that the yield curve does not go so long in the future, so that is the reason for the absence of secondary trading, and without secondary trading there are no real open market operations. Additional restrictive element for the development of secondary market is given by the NBY that provides a wide open discount window for these bills if there are some liquidity problems in the bank. Instead of selling these bills on secondary market to another bank, or arranging repo agreement, banks are trading with the central bank. Just for a comparison, secondary market of short term government securities is one of the most liquid in market economies and advanced transitional countries.

There are several reasons for very limited possibility in establishing liquid and long term government security denominated in local currency. First, participants in the financial market perceive currency risk as very high, so banks neither have the source for long term investments in their balance sheets, nor there are other players that are willing to do that directly. Second, liquidity premium for the long term security is too high, so the issuers are not willing to accept it. They are issuing short term security and roll it over when it matures. Third, there are no huge institutional investors like pension funds and insurance companies that need such financial instrument.

Even though, turnover of these securities represents 52.90% of total turnover on BSE, and 1.20% of whole number of transactions.

Commercial papers and short term bonds of companies are also traded just on a primary market. Maturities are very rarely over one month with little chance for development of secondary market. Because of huge credit risk of issuers, interest rates are between 1.8% and 3.2% per month. What could be easily noticed is that market participants anticipate credit risk very well, so the spread between interest rates of different issuers is very high.

Trading (better to say: issue) of these securities is on the OTC (over the counter market), but there is mandatory report to the BSE, for what 0.05% fee has to be paid. This trading represents about 40% of whole turnover on stock exchange and OTC (25% belongs to commercial papers and 15.40% belongs to short term bonds of companies). In the number of transactions, this trading represents 68.60%.

This market segment emerged spontaneously because banking sector was not able to find sources of financing for enterprises and it represents a good example on how there is no need for involvement of government in the process of developing financial market.

Trading with the old frozen foreign currency saving bonds (FX bonds)[75] started at the end of November 2001. From that time and before the new *Law on satisfying claims against public debt from frozen currency savings*, less than 1% of public

[75] That are savings that were 'frozen' in Yugoslavian and Serbian banks at the begining of 1990ies. There was not any repayment for years. During 2000. small repayments started and will last till 2016. That is because IMF imposes a restriction as precondition for a current 'Stand By Agreement' - no more that 0.9% of Serbian GDP can be used for satisfying claims against this debt. In the meantime, people receive bonds that could be sold with a discount.

debt was converted into the FX bonds, and about one half of bonds changed hands. Organized trading with these bonds takes part on the BSE, it is denominated in EUR and the settlement of the transaction is on the T+3 regime (three days after trading).

Trading with these bonds represents 1.40% of total turnover on the BSE, and there are several reasons for such poor liquidity. Government wanted to provide 'incentive' for trading and wanted to 'protect' the original holder of the bonds, so:

- conversion lasted few days and old people had to go several times in the bank;
- government gave strong 'recommendation' to banks not to buy the FX bonds from the people on OTC, than to advocate them to sell the bonds on the BSE. People had to go to the Central Register to immobilize bonds, to a broker to put signature on the agreement for trading on stock exchange, and at the end, back to the bank to open "foreign currency accounts of the special purpose", one if they want to sell their bonds and another if they want to buy bonds;
- payment gone through correspondent foreign banks, because of settlement in EUR, and people often had to wait more than three days with cost greater than 5% on small transactions;

It is important to notice that from the time when banks started to buy bonds on the OTC, competition on a buying side resulted in declining of implicit interest rates and discounts, and raising the price of bonds. On September 04, 2002, trading was like this:

Series	**Price**	**Implicit interest rate**	**Volume (EUR)**
A2003	92.00%	11.90%	1,707
A2004	81.00%	12.88%	1,182
B0000	48.00%	13.40%	60,213

The new *Law...* enabled conversion of total amount that was frozen into the bonds that matures from 2002 to 2016. Previously, it was possible to convert about 10,000 DM per saving book. Bonds are issued in 'book entry form', as an electronic file in Central Register, what gives the possibility for the government to limit the rights of the owners with excuse of development of financial markets.

In the year of privatization, equities of about 30 privatized companies were listed on the BSE. The method of privatization is in favor of strategic investors, and there are two models of auctions: first when the small share-holders are selling their securities and the other when the government is selling its stake, without any take-over bid procedure.

It is not hard to guess that shares of the one company are sold at couple of times higher price when the government is seller than when the seller are small share-holders. Neither the current, nor the draft of Securities Market Act has the privatization as the objective of regulation. As a result, there is no liquid market of equities. Discontinuous single price auctions are organized usually once in a month, and turnover of equities represents 3.30% of total turnover of the BSE.

Registration and transfer of ownership on equities is done within the Temporary Registry, which is a part of the Agency for privatization. At least, that is serious conflict of interest and an opportunity for corruption. Because of bad technical and IT infrastructure, the settlement cycle is unpredictable and can last for more than five days.

The major influence for further development of securities market will have *Securities Market Act and Foreign Exchange Law*. The first is in the stage of draft and the second was adopted during this year.

Foreign Exchange Law restricts capital outflow, so the Yugoslav citizens cannot buy securities of foreign issuers. That is a wrong solution because the investors are not free to choose about allocation of their capital, and that is a negative incentive for employment of capital that is now in ‘pallets’. Banks could deposit money in foreign banks, but they are not free to buy foreign securities either. That means that domestic investors are unable to hold low-risk asset like equities and bonds of well known foreign companies or foreign government securities. Because of that, institutional investors cannot sustain their capital in a long term, and there is a little possibility for developing of private insurance companies and pension’s funds.

Foreign exchange law enables denomination and trading of securities in foreign currency. That is a prerequisite for development of long term debt instruments.

Draft of the Securities Market Act stipulates that every new issue of securities will be in a book-entry form (dematerialized) as electronic file in the Central Registry. Central Registry, as one of the most important institutions in the financial market, should be non-profit, monopolistic institution with government as a major share-holder. By being non-profit, nobody beyond the state will be interested to get its shares.

The stock exchanges should be profit organizations that could be set up freely, with capital requirement of 100,000 EUR. However, some technical and staff requirements should be fulfilled too, what could be the great excuse for the government to forbid the establishment of new, privately owned, stock exchanges.

Trading with securities is allowed just on the stock exchange, with the exception of institutional investors who could trade on OTC too, what represents a serious violation of ownership rights. Capital requirement for the broker-dealer companies should be several times higher than now, what would have a negative impact on competition between intermediaries. Securities and Exchange Commission should have great responsibilities, it should be independent institution, but the time will show if that is possible.

The development of securities market is prerequisite for development of financial market and efficient allocation of resources, what is of great urge in transitional economies. Serbia did just first, but very insufficient step towards that goal.

STOCK EXCHANGE

While stock exchange in market economy operates continously, the days of any significant trade on the Belgrade stock exchange (BSE) are rare. During May and June 2002. shares were traded once per month, in July once per week. «Old savings'» bonds are traded daily, but the amplitude is limited to some tens thousends of USD. Contrary to usual crowd and bustle on world stock exchanges, on the BSE it prevails peace like in some rarely visited memorial, clients are rare and staff shortens time through conversations and computer games. The fact that the vital institution of market economy is not operating normally almost two years after democratic changes took place indicates that reforms have had not started yet.

Shares from state owned Action fund were traded just for 36% of their book value, indicating overevaluation of the booked value compared to market price. In order to be traded, shares need to be registered in the Temporary register. Until July 2002. the shares of just 200 among more than 1000 shareholders' firms were registered in the Temporary register. Even in these 200 cases the ownership structure was not adjusted to shareholders' books that are considered authoritative in legislation. It seems that shares for more than 1000 firms privatized[76] via insiders' privatization under Milosevic are traded informally outside the BSE. Trades on the BSE rises transaction costs, restricts ownership rights and lowers profits from trade. Trades outside the BSE are illegal according to current legislation, and some officials favor their legalisation. Although such an proposal is reasonable, officials should support legislative changes rather than the break of law.

Trades on the BSE are over-bureaucratized, complicated and expensive, with a lot of nonsensical solutions. In their first trade, shares are traded on prevailing price, based on book price. Trades are suspended if anybody offers a price that is for more than 20% higher or lower from prevailing price. Obligatory prevailing price and 20% limitation distorts normal trades, and by limiting the price reduces gains and so the incentives for trade. This method favors large buyers, what in practice leads to priveleges for management and what disadvantages small investors.

Although the price of a huge majority of shares is lower than book value, there are some exceptions. Shares from the “Apatin brewery” were once traded 15 times higher than it was their book value, and authorities declared this transaction void. Before that, equities of “Apatin brewery” were traded according prevailing price, what is usually considered as a “friendly price”.[77] The expectation of bureaucrats that share price will fluctuate just ±20% is completely unfounded, since the prices tend to fluctuate much more in the beginning phase of transition.

[76] Many firms were privatized during 1992-1993. via insiders privatization. Owners got shares under market value during hyperinflation, since share prices were denominated in dinars. Democratic party (DS) and its leader Zoran Đinđić, at that time opposition leader and current prime minister, have proposed revalorization of individual stakes in privatized firms in 1994. The motif for Đinđić and DS was to get demagogic votes: privatization was not just, nearly predatory, because new owners profited from hyperinflation. Milošević’s ruling socialists immediately accepted the proposal and drafted the law, since they were interested to regain the control over firms and economy. Socialists and democrats voted together for the legislation, privatization was declared void via revalorization, and the Democrats have sent the message about their similarity with Socialists. Independently of that who rules, Serbia is not safe place for investment – was another message still echoing in this country.

[77] In both cases the transaction parties gone to court and the cases are not solved yet.

In August 2002. trading rules were slightly reshaped, deposit for auctions is lower and the period for organizing auctions is shorter for two weeks.[78]

Shareholders in market economy may sell shares as soon as they like to do so. Shareholders in Serbia are first obliged to announce sale, at least 3 times in 6 months. Shareholders are free to make announcements wherever they like; however, adds in press are expensive and the most convenient way is to use the announcement blackboards in firms, which are again controlled by management. Managers may use this power to prevent the transfer of shares, protecting their managing positions as well. This way managers relax pressure emerging from share trades. On the other side, hostile takeover is illegal in Serbia. This restriction should be lifted immediately in order to enforce shareholders' rights and to stimulate market for managers.

There are no investment funds in Serbia, and there is no reason for them to come or to emerge, because banks dispose over large non-invested capital and citizens hold more than 4bn USD in straw-mattresses. Just the Raiffeisen bank Serbia has collected more than 140m USD in deposits until July 2002, and it has invested in Serbia just some 20m USD. This indicates a poor business environment and a lack of eligible firms and programs. The BSE fits well to this situation with its thin trade of 1.2bn USD this year.[79]

FISCAL SYSTEM

When reforms of fiscal sector started, the new Serbian authorities promoted the creation of transparent tax system, non-budgetary items abrogation, and tax evasion suppression – in short, they have approached to the Western countries best practices.[80] Principally, this is good direction of the reform, but a huge mistake has been done at the very beginning: the focus has been put on revenue side of the budget, i.e. on its increase by better tax collection. However, nothing has been done regarding either radical reduction of government spending or creating favorable

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[78] Instead of 33%, deposit will be 10% of the starting price. Period for notification of interest for auction is reduced from 15 to 5 days.
[79] That is the whole trade on the BSE from January 1 to the end of August, 2002. Cf. http://www.beolex.co.yu/trgovanje
[80] Cf. Popović, D. (2001), p. 1and 8.

business environment. Nourishing of "predatory state" is being continued, having as a consequence the emergence of such a business environment that is poor for new investments and that provides incentives to gray economy. Practice of informal taxes has also been continued,[81] although non-budgetary spending is somewhat limited.

While on the federal level just some fundaments of tax system, customs systems, and administrative taxes are determined, other relevant issues are defined on the republican level (more precisely Serbia, whereas Montenegro does not apply federal regulation since 1997). Partial reform of the tax system on the Serbian level has been accomplished by enacting tax legislation in spring 2001. It would be well if new authorities have also passed other reform law so quickly, and not just the tax ones. Hereby, aspiration to ensure a budget for bureaucracy is obvious. The number of different taxes has been reduced from 270 to 230, but the tax burden has not been relieved. It has rather increased because during Milosevic era taxes and other duties had been calculated according to official – and not the market – exchange rate; there were cases of tax forgiving for many firms; and tax evasion was much more extensive. From the table bellow one can see that some taxes have been reduced, some kept on same level, and some increased. Social security contributions have been lowered, but in the meanwhile, one part has been financed from donations.

Table 2. Some tax types and tax rates

FISCAL FORM	**Rates (according to previous regulation)**	**Rates (according to new regulation)**
Turnover tax	31%, 28%, 21%, 18%, 15%, 12%, 9%, 1%	17% + 3%[1)] = 20%
Corporation income tax	20%	20%
Personal income tax	14% (salaries); 20% (other incomes)	14% (salaries); 20% (other incomes)
Property tax	0.4%	0.4% - 0.8% - 1.5% - 2%
Tax on patrimony and gifts	2% - 3%	3% - 5%
Tax on absolute rights transfer	3%	5%
Social security contributions	26.6%	16.3%
Tax on salary fund	4.3%[2)]	max. 3.5%
Tax on financial transactions	0.3%[3)]	0.3%

Source: Popović (2001), p. 2.

1) This is rate of special federal tax on goods and services turnover.
2) Sum of previous payments for public utilities and residential dues.
3) Sum of previous solidarity contributions and solidarity tax on financial transactions.

81 For example, cost of corruption, inflation, half-voluntarily sponsorships, contributions to political parties.

Serbia is one of a very few European counties where VAT (value added tax) has not been implemented, but still exists the 20% turnover tax on goods and services and the lack of adequate tax information system is designated as a major reason for this situation. Personal income tax is still cedular. Employers' burden (payroll tax) indeed stayed unchanged since before reforms have started, approximately 0.78 dinars of various taxes and dues should be paid on 1 dinar of net salary and after implementing gross salary concept, the burden has been reduced to 0.72 dinars. Excess salary burden continued to have negative effects on employment and practice of stimulating gray labor market (employees receive some net salary but relevant taxes and other dues and contributions are not paid in respective budgetary accounts). Moreover, new legal solutions prescribe progressive taxation of physical persons realizing annual income above certain threshold, meaning discouragement of more comprehensive and qualitative work and punishment of success.

The authorities continually present 20% tax on corporate profit as a very low, although it is better to reduce fiscal burden in this area and attract investments instead of insisting that this tax rate is not higher than one in neighboring countries. In addition, services the Republic of Serbia offers for 20% turnover tax are far less good than ones of the similar price in neighboring countries. In the country where one of the major problems is overall poverty, it would be much more reasonable to reduce this tax rate on one-digit level,[82] if not to annul it. An absence of understanding by “reformers” for such rationale is shown in rejection of substantial fiscal decentralization and fiscal competition among municipalities and regions: if municipalities or towns disclaim its tax revenues, revenues are automatically transferred to the Republic’s budget and thereby losing a possibility of tax burden chain reduction.

Excise regime still exists and the state has determined that luxuries are things like table salt, beverages, etc. Excises stayed very attractive way of collecting budgetary revenues, as well as gray economy increase. Imposing high excises on certain types of goods stimulates development of illegal market of these commodities.

[82] This measure would not mean budget revenue decrease due to gray economy legalization and economy growth increase.

For example, cigarette black market is about 50%, and there are also markets of other excised goods. In August 2002, the Government proclaimed combat against the gray economy, which most certainly once again articulate its non-market orientation. The Program would consist of reinforced actions of financial and regular police corps rather then obviating key incentives to gray economy. The Government neglects that gray market is the most market-oriented part of Serbian economy differing from regular one only in three aspects. First, it cannot be viewed and screened statistically; second, official taxes are not paid (some eventually yes, but not all of them); and third, due to tax evasion, this part of the economy is illegal.[83] Adequate way of fighting gray economy does not consist in increasing already significant compulsion, but in eliminating causes of gray economy such as complicated regulations, high taxes and nonfunctional state institutions.

The Government constantly promotes struggle against smuggling,[84] but it is insincere, nonsystematic and occasional, so being consequently with little (if any) success. The question is whether it is more efficient to repeal excises, improve scope of tax collecting and avoid cost of ostensible "merciless combat", or preserve current condition. To show their "rectitude", reformers highly tax "luxury" such as cellular telephones, yachts and boats, weapons, what is a type of revengeful tax.

Predatory state operation can also be seen when considering fees on absolute rights transfers that have been increased from 3% to 5%, consequently increasing price of property rights exchange. This can only be interpreted as obvious evidence of a non-market way of thinking by new authorities. Additional proof of persistence is the level of tax on financial transactions (0.3%), up to recently linear.

During first half of 2002, particular taxes contributed to the Serbian budget as it follows: turnover tax 48.4%; profit tax 23.5%; property tax 3.1%; fees 3.1%; duties 7.3%; other revenues 14.6%. This clearly shows how obsolete and non-stimulating tax system Serbia applies.

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[83] Hereby "black economy", such as traffic of illicit drugs or illegal weapon trade, is left beside. These acts are crimes according to provisions of several other laws, like Criminal code.
[84] Creating cost for taxpayers.

Therefore, Serbia is a country where taxes are inappropriately high, there are some 230 formal taxes/burdens, and government spending[85] is above 54%. The rules of the game are instable, additionally aggravating business environment. Instead of the described one, tax policy in Serbia should be based on completely different approach: reduction of formal number of taxes/burdens; low taxes with unique rates (without tax exemptions); "fiscal federalism", i.e. competition among jurisdictions; implementation of 10% VAT rate and synthetic tax on income with flat (not progressive) rate; repealing of turnover tax, tax on financial transactions, capital gains tax; excise taxes minimizing and its reduction on just several products. Thereby, entrepreneurial spirit would be instigated; gray economy legalization would begin; and instead of socialist (redistribution of poverty), the country would get a pro-business tax system.

Law on Extra-profit[86]

After October 5, 2000, new authorities have stood under pressure and felt responsibility to punish close allies of the previous regime. However, the authorities did not prosecuted political and classical criminals of Milošević's era, but "the sword of the justice" has been directed toward businessmen and firms. Therefore, the category of the "extra profit" has been devised by June 2001, encompassing all sources of proceeds from preferential position.

The Law has revolutionary-political character; it is discriminatory and gives huge discretionary power to authorities when deciding who will come under its attack. The Law is retroactive and in collision with other laws. It covers the period of 12 years. If a firm, subject to the law by legislator's decision, cannot provide evidence on its revenues for the entire period[87], it can easily happened a firm, although it has not used any privileges, that it is obligated to pay the tax. Law predicts fifteen-day deadline for

[85] Where, turnover tax on goods participated with 23.5 percentage points, turnover tax on services 11.1 pp and excises 13.8 pp. Cf. Dumezić 2002, p. 29.
[86] Law on One-Occasion Taxation of Extra Revenue and Extra Property Acquired by Using Special Privileges in Period January 1, 1989 - June 1, 2001.
[87] According to the Law on Accounting, firms are obligated to keep only annual balance sheets and earnings calculations for ten years. There is no longer obligation for other documents; semiannual balance sheets and accounting documents have to be kept five years, and sales and control blocks, accessory formularies and similar documentation for two years.

collecting evidence on twelve years business operations although commercial legislation allows six weeks deadline for annual balance sheet.

Apart from being opposite to the rule of the law cornerstones, the law worsens an already poor business environment causing money outflows toward gray market and abroad. Socially owned firms, subject to this law, are put in unfavorable position since the law does not charge firms' managers, who on the one hand gained personal fortune and one the other hand caused loss to the firms by poor management. Therefore, the firms are subject to the Law on extra profit, although particular individuals used all the benefits. Law charges invoiced amounts of purchased foreign currency, so if the firm performed its operations legally according to existing laws, now it is a subject of retroactive Law on extra profit. Similar situation is when considered quotas and other non-tariff barriers: nevertheless, Milošević's regime was not able to allocate all contingents to its collaborators, rather one part was assigned to firms not belonging to ex-regime nomenclature.

The article of the law referring to punishments specifies that person not filling in its tax form will be fined by two to tenfold of evaded tax amount, although the law does not specify who and on what basis will determine it.

The law does not accept limited liabilities, and firms' owners are liable with their overall property, even with property of their close and distant family members –up to second degree of kinship in-low relatives.

The results of enforcement of the extra-profit law are disastrous to its authors – till August 2002 just 60m USD has been collected, although 800m USD was expected. Moreover, a half of this sum was collected from one firm. A number of firms (e.g. "Simpo", "Lutra") charged with large amounts succeeded to significantly reduce its obligations; many firms were unaccountably exempted from taxation; and some firms, founded and enormously expanding during previous decade due to close relationships with former regime, were even not subject of the law (e.g., "Delta").

Serbian authorities have announced repealing the Law on extra profit since October 2002, having in mind its unsuccessful implantation, even from government's point of view, and its inconsistence with market approach. However, "predatory state" and it ministers are not still and silent, since they already announce new laws with similar purposes as previous one. For example, "…Božidar Đelić /Serbian finance minister, edit. / said, tax law would enable tax authorities to compare taxpayer's property and life style with revenues reported to tax office. If significant discrepancy between two categories exists – administration will begin with the action."[88] "Life style identification" of any individual is not possible without spying and other police-state measures. In addition to that, the authorities are announcing new Custom law, according to which customs officials, financial and regular policemen will have the right to control people and premises not only on state borders, but on entire Serbian territory as well. The law also allows that officials may enter into apartments, premises, and houses for the purposes of such control. Beyond these two draft laws, new legislation on special prosecutor's office and special forces against organized crime has already been adopted. These laws significantly simplify trespass procedures, arresting, following, property confiscations, imprisoning, etc. completely undermining basic safety standards of individuals and property. These laws could not function without "police state" that obviously has deep roots in Serbia since it survives during various regimes. Where these laws function, a message goes on how undesirable businesses are and that government has robber intentions toward its citizens.

BUDGET AND STATE EXPENDITURES

It was common practice in former socialist countries to report higher GDP, making the sence of succesful economic progress. Contrary to that, during transition the GDP figures are lower due to tax evasion and a lack in solid statistics. It is especialy the case in agriculture, trade and services. Black market seizes large portions of economy in transition countries but Ukraine, Bosnia Herzegovina and Serbia are clear "leaders". The fact makes it difficult to compute exact GDP and government spending. Table below shows the dynamic of FRY's GDP.

[88] Korica-Vukajlović, 2002, p. 16.

Table 3: GDP development in FRY[1]

	1997	1998	1999	2000	2001	2002[2]
GDP growth in % *	10.1	1.9	-18.8	5.0	5.5	4.0
GDP growth in % **	-	2.5	-18.0	5.0	5.5	4.0
GDP growth in % ***	7.4	2.5	-23.5	6.4	5.5	4.0
GDP growth in bn USD*[3]	19.7	17.0	18.6	10.8	12.4	-

* The Economist Intelligence Unit: Yugoslavia, July 2002, p. 7.
** Balkan Times (www.balkantimes.com/resource_center2/sebianLatin/country_info_yugoslavia.html
*** The Vienna Institute for International Economic Studies.
1) All data are for FRY without Kosovo. 2) 2002 estimated. 3) Serbia contributes approximetly with 93% in federal GDP.

The table reflects congruence in calculating GDP among several sources for the period of 2000-2002. Estimates for 2002 are probably overstated since the data for the first seven months indicate a GDP growth of around 1.2-1.5%, and the growth of physical volume in manufacturing for 0.4%. EIU's GDP growth forecast of 6% for 2003 is also unrealistic. It seems that EIU accepts the same approach as the Government of Serbia that in its "Economic development strategy until 2010"[89] projected long term growth rate at 8.55% and in some sectors as high as 15%. If nothing changes effectively in "the rules of the game" Serbia can hardly expect average growth rates higher than 2% for the next decade. With this tempo of development a country needs 35 years to double it's GDP *per capita* on the real basis. The government will of course overstate rates in time of budget planning making it easier to increase budgetary spending.

According to the EIU data, cited also by the «Heritage Foundation», public spending in Serbia in 2001 was 24% of GDP. If this were true, Serbia would be among the European countries with lowest public spending. Unfortunately, spending of federal state, Vojvodina autonomy and municipalities was not included (Serbia is funding entire federal budget which accounts for 7.5% of Serbian GDP as Montenegro stalled contributions years ago). By adding contributions to the pension system total public

[89] See. **Strategija privrednog razvoja …** (Economic development strategy of Serbia until 2010), (2002) p. 87. 'The strategy' is expression of a socialist approach where omnipotent planers design economic development without taking into account the reality, and as such it represents a fabrication. Ironically, such a famous publication like the EIU permits arbitration like the following: "The aggregate goals of the ***Strategy*** are not unrealistic – the Serbian economy is capable of growing at around 10% a year for an extended period of time." Cf. EIU, July 2002, p. 19. We can agree with the EIU, if Serbia reaches the level of economic freedom such as Estonia or New Zealand. There are scarce indications for such unfolding.

spending reaches 54% which places Serbia at the top of European list, just behind Sweden and Montenegro. The portion is probably even bigger since a number of state hospitals, schools, police, army and public administration are not paying for utilities and supplies. Informal taxation of firms to support governmental activities also increases public spending.

The WB standards suggest that countries with income *per capita* at 1,500 USD should limit public spending at 20% of the GDP, which implies that Serbia should decrease it's spending more than 2.5 times! There is tiny possibility for this as state expenditures for 2002 were projected at even higher level than a year before. Budget amounts to 234bn YUD (3.78bn USD)[90], i.e. 2.6 percentage points above 2001 figure taking into account 4.5% GDP growth rate.[91] Deficit was planned at 4.3% of projected GDP and will be financed by donations, privatization revenues and NBY credits. The budget is expected to reach 24.1% of GDP at 20% inflation rate in 2002. GDP is estimated at about 14bn USD. Dispersed on 7.6m large population of Serbia it results in GDP/pc of more than 1,900 USD. General balance of public revenues and expenditure of the Government of Serbia calculated GDP at 979bn YUD, which at exchange rate on September 16, displays GDP/pc[92] of some 2,060 USD. It seems that the Government calculates GDP at 1,900 or 2,060 USD when it is filling the budget, and at less than 900 USD when negotiating with international funds for the IDA credit conditions are in question. Extension of this trend would lead to overall spending of 7.6bn USD or 54% of GDP. Huge state spending confirms that tax rates are very high, which combined with complex regulation and constant changes in regulation constitute three main factors of poor business environment.

Social spending

Major budget items comprise allowances for employees (750m USD), goods and services (400m), payment of interest for international credits (370m), subsidies

[90] See 2002 Budget of Republic of Serbia, Draft law, p. 5
[91] Estimation of the Economics Institute (see **Ekonomist magazin**, July 29, 2002, p. 28), GDP growth in first half of this year was 1.5% which relatively increases state spending.
[92] See General Balance of Public Revenues and Expenditure of the Government of Serbia; As stated in the Balance, GDP is quantified at 15.8bn USD, total state expenditures 47.62% of GDP which together with Federal state payments forms 55% portion of Serbia's GDP accounting about 8.7bn YUD.

($500m), pensions (740m), social welfare (380m USD), etc. To social care and social programs were alloted 45 bn YUD (725m USD).[93]

The number of statistically registered unemployed persons is 850,000 (official rate of unemployment in 2001 was 28%). In additon, the number of surplus of employed[94] manpower is estimated around 700,000, which rises the number of socially endangered to 2m. Serbia, like no other transition country experienced massive inflow of refugees and it currently hosts 200-300 thousands of them from Croatia, Bosnia and Herzegovina and Kosovo.

Although average salaries rose from 45 euro in October 2000 to 150 euro in September 2002, the general level of prices jumped to a simalar degree, so that purchasing power of salaries remained low. Poverty and misery are widespread outside urban centres. According to some analysis almost 60% of citizens lives below poverty line (2 USD per day). The WB reports that poverty now is twice as it was in 1990. Arround 12% is poor by the standards of «World Food Program», while another 20% is "very poor".[95] The consequences of grave socio-economic reality can be illustrated by surge of suicides, murders, mass killings, robberies and thefts which places Serbia in violent societies.

Pensions have been paid regularly with accruals for three months. However, pension reform is based merely on extension of age limit for five years[96] and shrinkage of rights on insurance for unemployed. The number of pensioners is huge (employees-contributors ratio is 1.23:1) which together with ageing of population posts financial burden that current *pay-as-you-go* system is not able to cover. Even now, a significant part of pensions is covered from donations and budget.

Health care and education sufferred from the absence of any kind of reforms. The post of health care minister was vacant for six months, which illustrates consistency and enthusiasm of those who should introduce changes to public and implement them.

Education system is anachronous, teachers are unmotivated and corruption is widespread.

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[93] Subsidies to agriculture and depressed price of electricity and utilities should be added, too.
[94] It is expected that in the process of restructuring some 100,000-150,000 workers will loose their jobs in 2002, though there is little possibility of this to happen regarding the current pace of privatization.
[95] See EBRD, 2002, p. 12
[96] Which reduces chances for younger to get jobs.

It seems that authorities lacked strenght to make necessary effort to explain to voters and general public the reasons for non-sustainability of present systems of education, health care, pension insurance and social welfare. There is still strong linkage beetween anticipated social safety net and state in vast majority of population, which is a legacy of inherited paternalism. In analogy to the absence of reforms there was no change in populations proclivity towards self responsibility, competition and freedom of choice in respect of social care, education and safety in “third age”.

The government has used substantial means for solving acute problems and prevention of resentment of employees and for severance payment to workers being laid off[97], thus with no intention of making definite institutional re-arrangement. Financial support to unreformed systems of education, judiciary and health care spreads disastrous message: wages are not linked to productivity since they can grow no matter of reform paucity. In these fields there was not clear break with Milosevic regime because to many public servants who violated laws, moral and professional standards have not lost their jobs and privileges. Clean up ended on ministerial and their assistant’s level. The lack of basic refinement leads to conclusion that the former violators were awarded with higher incomes. *Status quo* is preserved by additional funding of unreformed institutions.

These are the reasons why enthusiasm that existed two years ago is wasted irrevocably, since 27% of population supports current way and pace of market reforms, although DOS has had political approval of more than 60%.

Social policy must be aimed at establishing of conditions for sustainable development rather than at preserving the *status quo*. Clear message must be sent: the only efficient policy that reduces poverty is economic growth based on new jobs and higher productivity where social policy is targeted at safeguarding of incapable citizens.

FOREIGN AID AND CREDITS

As one of its greatest successes the “new authorities” have pointed out to the amount of money received on various donor conferences, as aid for the revival of Serbia.

[97] With 4bn YUD government serviced social programs of excessive labor force in 17 companies; 1.5bn YUD has been spent on severances for 10,000 former employees of liquidated banks; subsidies to companies in process of restructuring took additional 6.5bn YUD.

Foreign aid was partly granted as donation and partly as soft loans. The donors are mostly the governments of developed countries and non-market funds, such as the WB, EBRD, and IMF. The biggest donors are the EBRD, European commission, European Union, European Investment Bank and the Government of Italy.

Total amount of funds agreed from the end of 2000. until June 2002. moves around 2.778bn Euro – 439m in 2000, 1.397bn in 2001. and 942m in 2002. The transfer of agreed funds is postponed, compared to promises, what is illustrated in Table 4. In 2000-2003. it is expected for 2.44bn Euro to be delivered.

Table 4: Dynamics of foreign aid, in millions of Euro

Fiscal year	2000	2001	2002	2003
2000	157.85	266.29	8.57	-
2001	-	296.17	526.59	391.16
2002	-	-	346.09	450.11
Total	157.85	562.46	881.25	841.27

Source: **Status report**, 2002, p. 4, 7.

Nearly all financial means in 2000. and 2001 were donations. Contrary to that, the proportion of donations in 2002. and 2003. will be 58%, and 26% respectively, while the rest will be soft loans.

The total amount of funds agreed whose realization will last several years (until 2004) is close to the average annual amount of FDI in Hungary in the last ten years. The effects of those two cases are in reality completely different.

Sectorial division of donated funds is the following: the biggest amount of funds agreed goes to the energy branch, followed by social affairs and finances, and the rest goes into the private sector, health care, support to the budget, banking reform, agriculture, local government, etc.

The effect achieved can vary a lot. On the one hand, these funds are being used to fill in all the “holes” into which the private capital wouldn’t have interest to flow (electricity), and that is good. The danger brought by the donations is the weakening of the motives for reform. Governments receiving funds try to satisfy interest groups and don't risk the loss of votes caused by eventual structural changes. Secondly, if the amount of money at the state’s disposal increases, it is increased the political and economical power of the bureaucrats and the state. Thirdly, some space opens up for corruption. It is rather questionable what would have happened if there were no donations for the fulfillment of some large “holes” of Serbian economy, such as energetic, social affairs, etc.? Would the authorities be forced to speed up the reforms or would it look for alternative sources of money, through privatization, sales of monopolistic rights, quotas and licenses?

The fact is that the donations were used as a good base for political marketing of the new authorities, actually as a proof of successful leadership in domestic and foreign policy. However, any other post-Milošević government would also get, if not the same, then the approximate level of credibility in international circles, financially materialized through aid. The credibility awarded to the Government in the eyes of foreign governments and non-market funds (influenced by the governments and not by the markets), for political cooperativeness for example, is something completely different from the credibility of a country for private domestic and foreign direct investments, which can be achieved only through the creation of favorable conditions for investments, and not through some political moves.

Donations are economically far less efficient from the direct private investments. They go mostly into budgetary consumption and subsidies.[98] Even when a state uses them for investments, their efficiency level is much lower than that of the private investment. Unlike donations, whose amount does significantly diminish before they reach the target (they diminish as a result of the costs of equipment, expert work, corruption, etc.) private capital brings even more advantages – increase in productivity and employment, transfer of know-how, increase in exports, etc.

So, instead of asking for aid and soft loans, the Government should work on the creation of good business environment, favorable for another entry of private capital, which will have a full range of positive effects. “Trade, not aid”. The things on that field, however, are going in a completely opposite direction. After several unsuccessful

[98] With corruption and wrong directing of aid the social-economic effect of the donations in considerably smaller than the donors intended and much smaller than the authorities publicly declared. In Serbia there was no systematic research of the use of the donations. In the newspapers a few affairs with the use of the donors' aid were noted, such as the illegal sale of the fuel designated for the public heating of the town of Kraljevo, the missing check of 1m USD from a Greek bank, illegal sale of humanitarian aid to some enterprises and on the public markets. The studies done in neighboring Bosnia estimate that out of 6bn USD of foreign aid between 1996-2002 almost one half disappeared through corruption.

attempts to attract FDIs, by organizing the meetings in Belgrade for the Serbian businessmen living abroad and for the western businessmen and by visiting well-known companies abroad, Serbian Prime-minister Zoran Đinđić published an article in “Glas javnosti”[99] inviting the IMF to approve substantial funds to Serbia, which would be used to finance the public works on the large scale.

After pointing out that the IMF fosters basically sensible policies, asking countries to promote stabilization, liberalization and disinflation and being rightfully strict toward most of the countries, Đinđić says that there are some specific countries with a “specific model of transition” where the IMF should essentially step away from its current philosophy and approve to the Government of Serbia the money for public works.[100] Đinđić tries to delude the IMF by stating that the reforms in Serbia have gone too far. He promises to develop market economy in Serbia through the administrative measures, which is absurd, because the way to a market economy leads only through privatization and creation of favorable conditions for private investments, and not through the spreading of already dominant role of the state. Đinđić is asking for large public investments, active policy of employment, budgetary indebtedness for the sake of fostering economic growth, selective subsidies, additional protection of the domestic market – which are all the measures that enlarge rather than reduce the role of the state in the economy and which altogether fit into old communist policies that have turned the economies of the Eastern European countries into ruins. The proposition of the Serbian Prime-minister comes down to the financing of the consolidating of corrupt socialism in Serbia with the IMF money, i.e. the money of the western taxpayers. For now, the IMF has remained silent.

After everything that happened in Serbia between1990-2000 the western powers could hardly avoid assistance to the country, regardless of whether that assistance would come as donations, soft loans or debt cancellation. If at the same time the Serbian

99 Daily newspapers »Glas javnosti«, April 30 - May 2, 2002.

100 “The different approach is towards the countries in transition, where the present authorities inherited a destroyed economy and where a concept of administrative assistance to the economy should not be discarded immediately. That is the case mostly with new administration for which one should not automatically assume that is incompetent and corrupt. That administrative assistance to the economy would mirror itself in large public investments and active policy of employment, budgetary indebtedness for the sake of support to the economic growth, selective subsidies, protection of some parts of the domestic market until the economy becomes competitive.” Ibid. Đinđić, 2002.

Government has worked on the creation of worthy conditions for private investments, and if it has used western aid for the financing of enlarged transactional costs of the reform, including the budgetary deficit unavoidable in the first two years of transition, the reform in Serbia could have been characterized as a very successful. As there were no serious reforms, one cannot avoid the impression of considerable negative influence of foreign aid upon the lack of reforms. Although the capability of the western countries to rationally use the aid was limited by the nature of the problem – it is hard to avoid the conclusion that the country that got rig of Milošević does not deserve the support – some ways to do that still existed. First, donors were able to separate the humanitarian aid from the rest of aid. Second, western governments and non-market funds were able to monitor the extent of reforms in Serbia. Third, if the reforms were missing, they were able to provide nothing beyond humanitarian aid (mostly dedicated to physical survival of the population); its use might be strictly controlled, as it is done during Milošević's rule. Four, other donor and credit assistance should have been conditioned by overall reforms, rather than with a handful of conditions, operatively important but yet systematically less important.[101]

The Congress of the USA first noted that fallacy in the western approach, apart from some rare analysts. The Congress has moved to use the legislation in 2002, in order to request from the American administration to make its aid to Serbia conditional upon the reforms in Serbia. Therefore, the Senate Committee for International relations requested that Serbia, if it wants to get 115m USD of aid in 2003, has to look upon a more serious break with Milošević's legacy: "The Committee notes, however, that while Milošević has been out of office since October 5, 2000, many of his unfortunate legacies continue, including an unreformed State security apparatus and military, a politicized judiciary, and political and financial support to hardliners in Bosnia's Republic Srpska and northern Kosovo."[102] Apart from that, the Senate quotes the pressure upon the media, weak cooperation with the ICTY and the lack of economic reforms as the reasons for this conditioning. If this kind of opinion would have prevailed in the West from the very

[101] If there were systematic changes the cooperation of the Serbian authorities with the ICTY, the end of assistance to the Bosnian Serb Army and repatriation of the prisoners between Serbia and Kosovo would not be a problem.
[102] Citation from the material »U.S. assistance in 2003«.

beginning of the structural assistance to Serbia, it would exercise a strong pressure upon the authorities in Belgrade to speed up reforms. Of course, there are no guarantees that the authorities in Belgrade would go for the reform even in that case, but at least the incentives to do that would be much bigger. Although some chances for this kind of change were lost, it is still not too late for that.

A special episode of foreign aid is so-called technical assistance, which consists in providing the intellectual services to a recipient country. It seems that these forms of assistance are more efficient the more precisely their purpose is determined, the more their providers take into account informal rules in the targeted country, the more precisely their aims, target groups and objectives are determined and the bigger the competition for getting the funds is. The least useful projects are those where the consultant companies define unrealistic aims in order to influence the domestic politicians when it comes to some legislative solutions and public policies, which of course ends up as one big nothing. Those kinds of promises are often just a mask to waste the money, where it emerges a cartel of foreign consultants, diplomats, some domestic politicians and parts of the domestic press and the NGO sector. After the assistance ends up, foreign consultants go back enriched, domestic politicians and foreign diplomats are happy because they got the money for "cooperation" and the problem remains where it was. These consultant-diplomatic-political ties spread a negative way of thinking, because all of the terms such as the market, competition and entrepreneurial initiative are proscribed, and actually dominating program is the one of "Government, connections, coteries, corruption", which has nothing to do with the declared aims of the "technical assistance". Therefore, some of these programs bring nothing but the damage, because instead of the development of the spirit of personal responsibility and market democracy under the rule of law, they support the arrogance of bureaucrats, ignorant consultants (who often don't know the basic facts about the country in which they work) and illegal enrichment.

CORRUPTION

The FMC authors do not share two widespread views regarding corruption. First, that corruption consists in misuse of public positions in purpose of gaining private profit only. Second, corruption is not predominantly a moral problem.

Talk about corruption often refers to corruption in the state administration, and the WB adopts such a definition. Nevertheless, corruption is a broader issue. It occurs in all cases when principal-agent relationship exists, and the agent is able to privatize or sell illegally certain rights since principal is not able to control sufficiently the behavior of agent.[103] Due to market pressure, the level of corruption is rather low in the private firms or their associations. Since there is no such kind of pressure in the public sector, corruption is mainly the problem in state administration.

Related to the second point, corruption is immoral in normative sense, but this is not its' main property. In positive sense, corruption is a mere consequence of the agents' rational behavior under circumstances.

Similar to thieving or rent seeking, corruption does not create new goods, but just redistribute the existing ones. Instead to be used for productive purposes, resources are wasted in unproductive activities.

Adherents of the normative approach plea for tight laws and their strict enforcement, for imposition of moral codes, rigorous control of public officers, "public awareness campaigns", and creating special government's departments as a tool for fighting corruption. They neglect that corruption that way may be only slightly, but not seriously reduced. As long as rents exist, there will be those to capture them, and the level of corruption will remain approximately the same. On the other hand, positive approach to corruption emphasizes the change of incentives and rents reducing. In practice it means taking the government apart from the economy (deregulation, privatization), restraining bureaucracy, and eliminating corruption-generating mechanisms. In order to develop specific anti-corruption tools the concrete, case study-approach is needed. If some administrative procedures are complex, they should be eliminated or simplified. If bureaucrats have a lot of room for exercising discretionary

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[103] See Colombatto 2001; Prokopijević 2002; Tasić 2002;

power, the extent of that power should be restricted. If only one bureaucrat is in charge for certain procedure, alternatives should be provided, avoiding employment of new bureaucrats, but letting different incumbents be in charge for various seals or approvals. However, these moves will remain without significant result, if they are not accompanied by improved transparency of operation in the state and in its' agencies, with more efficient judiciary, and greater incentives to denunciate corruption. Positive approach insists on increasing the price and decreasing the profit from corruption.

Corruption is widespread in Serbia, which places this country at the very top among the European countries.[104] Corruption and gray market have developed significantly during 1990ies as collateral of the UN economic sanctions, imposed to Serbia and FRY. Transparency International ranked Serbia on 90th place out of 99 countries in 1999, with the index of 2.0, and on 89th place out of 90 countries in 2000, with the index of 1.3.[105] "Global Corruption Report" for 2001 does not include Serbia. Serbia (FRY) is not on the official TI list for 2002,[106] but by the unofficial one it is ranked 93rd out of 126 countries, with the index of 2.6. It is an improvement compared to 2000, but still very poor result. Serbia is not ranked by the "Opacity Index" in 2001, done by "Price Waterhouse & Coopers", that encompasses around 60 countries in the world. This and the absence from the TI lists is a signal that firms are not interested to invest in Serbia, so that they are not willing to order the research from the TI. (TI researches have been undertaken during Milošević's regime because political interest of many governments and international organizations existed.) According to the study "Nations in Transit", which measures the corruption level on the scale from 1 (the lowest) to 7 (the highest), FRY is ranked among the worst off countries with the score 6.25, together with

[104] In spite of common assumption that there was no corruption during Tito's regime, this conviction obviously is not true, because some classes lived far above the standard they could have afforded by their official incomes at the time. Corruption existed on the top bureaucracy level, whose obedience was purchased by extra-incomes and gifts the regime enabled them to obtain, as well as in the some business transactions. It was not written much on corruption then, and even if somebody was accused for corruption, it meant that he made a political mistake, and corruption was often an excuse for charging him. Similar practice has been continued under Milošević's regime, during which vigorous boom of corruption occurred. While under Tito centralized systematic, grand corruption and small corruption were moderate, Milošević centralized grand corruption, but small corruption was decentralized and widespread.

[105] The TI scale assigns the index 10 if there is no corruption and the index 0 if corruption is omnipresent.

[106] At least three independent inquiries are needed to be included in the list, while for FRY and Serbia, only two were performed.

Azerbaijan, Kazakhstan, Russia, and Turkmenistan.[107] Researches undertaken by Serbian NGO's show that corruption is widespread in Serbia, which places the county among the 2 or 3 worst off in Europe.

Fight against corruption is exacerbated by several factors. The authorities announced to fight corruption, but they did nothing in reality, because it is a source of their revenues. Second, normative, moralistic comprehension of corruption prevails in public, which makes the fight more difficult. Third, there is a little experience of the citizens, NGO's and the others with fighting corruption under transition conditions, with pathologies inherited from previous era. Forth, the width of the phenomenon creates feelings of omnipresence of corruption and helplessness of the people. Wrong comprehension that corruption is acceptable when salaries are low takes place. Salaries are low in the private firms as well, but corruption is not there because of market pressure and different incentives.

Within the Anti-corruption strategy in Serbia, presented in September 2001, the Council and Operative initiatives started. Under the Operative initiative Committee for Fight against Corruption, Anti-corruption teams, and Special Teams have been formed. Under the Council initiative, the Council for fight against corruption has been created. Due to wrong orientation to the moral aspects of the campaign and constraining the campaign to verbal level only, Government's actions remained without any result. There are no institutional changes, which are the only real strategy in fighting corruption. Almost all institutions of the previous system notorious for corruption survived, while new corruption-generating institutions are created, like the extra-profit Law, Fund for guaranties, Agency for small and middle-size enterprises, NSI, tenders with more than one criterion, monopoly laws (oil, games on chance, tobacco). Among the anti-corruption measures undertaken by the Serbian and Yugoslav Government are to be found market liberalization, import-export liberalization (especially canceling the system of licenses and quotas), cancellation of double exchange rate, more transparent budget (although not transparent enough yet).

[107] See, Nations in Transit, p. 31, on the web site "Freedom House".

Because of wrong strategy of the Government and some NGO’s in the anti-corruption strategy conceiving, costs of corruption rather increase than decrease, since the costs of anti-corruption campaign are now added to them. Namely, moralistic pressure for reducing corruption induces greater bewares of bureaucrats, and greater expenditures for fighting corruption.

Why does the campaign exist at all? Probably to pursue two important interests – politicians’ interest to continue to collect bribes and the interest of voters, some social groups and NGO’s which want something to be done in fighting corruption. This campaign is aimed to make an illusion that there is a fight against corruption, and to change nothing in fact, even to worsen[108] the situation, because the alibi of ongoing campaign now exists. It does not mean that some small fishes will not be caught for corruption, it is even possible that establishment sacrifices some big fish in order to get public alibi for enriching itself.

C. POLITICS, STATE AND LEGAL SYSTEM

Milošević failed to establish a classical dictatorship due to several reasons. First, Montenegro was defined as particular federal state, and after several years of support to his power, the Montenegro authorities have withdrawn it in 1997. Second, Milosevic’s party (SPS) has never obtained majority on elections in Serbia (with exception of elections in 1990), and coalition partners had been necessary for government forming.[109] Third, opposition parties, independent media, NGOs and citizens' initiatives existed in Serbia. Fourth, opposition coalition "Together" won elections in around 20 biggest cities in Serbia in 1996. Fifth, since the end of the cold-war, international environment for dictatorships has worsened in Europe, so FRY and Belarus functioned as

[108] Some NGO’s like “Resistance” (Ser. Otpor) aimed their campaigns at developing consciousness, more stringent laws, better control, which are all actions that can only prolong the existing situation. The movement “Resistance” contributed greatly to getting rid of Milošević. Thereafter, it fell victim of internal disputes that led to its dissolution into several fractions, and some its’ leaders were alleged for corruption in the press. (The same happened with the Government of Serbia Council for fighting corruption, which after a year of existence has not done anything noticeable yet. In the meantime, Slobodan Beljanski, the Chairman of the Council, has resigned in June 2002, and several other members announced a similar move.)

[109] That was New Democracy (ND) and Serbian Radical Party (SRS)

quasi-dictatorships. Sixth, Milošević succeeded until 1997 to escape direct confrontation with international community, and got support from some major powers. After 1997, Milošević entered the confrontation, and instead of the "guarantor of peace" in Balkans,[110] he became "the international pariah" and the "Balkan butcher". The UN sanctions and the NATO military intervention in 1999 definitely weakened economic and politic basis of his power, fastening his fall.

Due to high costs of his politics, activities of the Serbian opposition supported by the Western democratic forces, and quoted limitations, Milosevic lost elections in 2000 and for some time it seemed that idyllic existed between new government and society. Immediately before and after their arrival to power the DOS politicians put high on their agenda: a country reintegration into world, separation of power, independence of judiciary, state decentralization (including Vojvodina autonomy), solving problems with Montenegro, good status for minority rights, independence of media, the autonomy of university, freedom of association and fast and deep economic reforms. Later actions were not conform to these promises.

Country reintegration into the world

Only insignificant part of the announced changes found its way to practice. Some spheres were not touched, from reform not to speak at all. FRY and Serbia became members of some international organizations, although not of several important ones. At the end of 2000, FRY and Serbia became UN and OECD members, and at the beginning of 2001 relations with IMF, WB, EBRD were re-established. During 2001, Serbia and FRY became members of BIS (Bank of International Settlement), CEI (Central European Initiative), ILO (International Labor Organization) and WIPO (World Intellectual Property Organization). In June 2001, negotiations with former Yugoslav republics about succession were completed, and in the fall of the same year, negotiations with the Paris

[110] For example, until the summer 1997, USA implicitly supported Milošević, and it was obvious when they allowed Serbian "Telecom" sale to Greek and Italian companies for 1bn USD, although Serbia was under partial UN sanctions. This transaction was probably compensation for Milošević's signing of the Dayton Agreement and it could not be possible without USA support. After 1997, American policy toward Milošević was substantially changed culminating in the NATO intervention in FRY during 1999.

Club resulted in writhing off some 2/3 out of 4.7bn USD large debt, while the rest 1/3 of debt was reprogrammed. From October 2000 to June 2002 Serbia spent 1.2bn USD of the foreign donations and credits mostly collected on the donor conference in June 2001. Even two years after changes took place, FRY has not become a member of the CE (Council of Europe) and WTO (World Trade Organization), and it failed to enter negotiations or on the Stabilization and Association with the EU and to enter NATO's Partnership for Peace.[111] With the ICTY,[112] FRY has established only partial cooperation about extradition of indicted individuals by opening the office in Belgrade and through selective access of the ICTY to certain documents. Even this cooperation is the result of great pressure on FRY and treats that financial aid would be withdrawn.

Separation of Powers and Judiciary

Instead of division of powers, new leaders started a passionate race for getting control over state and its agencies, preserving old constitution and laws proclaimed under Milošević. Two years after the change of government, Đinđić controls the Serbian government, while Koštunica controls the Army and Federal government. Both leaders share the conviction that separation of powers would restrict their prerogatives. Consequently, the huge majority of previous legislation stayed enacted, nearly nothing had been nullified, while the new laws, although they have passed necessary procedure, were not implemented in real life.

Except for insufficient number of promulgated laws that threat state organization and judiciary, a great problem is the lack of necessary institutional changes that would provide efficient implementation of promulgated laws and a legal framework for changes.

Keeping in mind the lack of institutional reform that was necessary to change rules and incentives, no wonder that the substantial changes in legal and political field are still missing: the reconstruction of constitution has not even attempted; political system is not changed, as well as the electoral system. Basic characteristics of constitutional and

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111 Although relations' improvement, until October 2002, FRY and Serbia have not became members in "Partnership for Peace", and so there is no point to discuss eventual entrance into NATO.
112 International tribunal for prosecuting persons responsible for serious violations of human right in ex-Yugoslavia between 1990-1999.

legal system established during ten years of national-socialist regime are still unchanged: so called "socially owned property" still exists as constitutional category; division of power and independent judiciary principles have not realized; power is manly concentrated in executive branch. The main reasons for hesitation of the ruling elite to reconstruct the whole society and to give up a huge discretionary power consists in privileges it exploits from that (personal enrichment, exercise of power and control of all segments of social life).

After changes took place, judiciary is less instrumental in comparison with Milošević era, but still far away from getting real independence. Legal system reform and the rule of law, as important economic reform presumptions, have been just started with five judiciary laws. Additional problem consists in temporary lack of coordination between legal and economic reforms. Administration of justice reform, mainly judiciary reform, aimed to organizational, personal, financial, expert and technical training for efficient and qualitative proceeding with documents about economic reforms, contract parties relations, property rights and creditors protection, had no results. Five laws have passed legislation on January 1, 2002 (Law on Court Organization, Law on Public Prosecutors' Office, Law on Judges, Law on Administration of Justice High Council, Law on Court and Public Prosecutor's Offices Headquarters and Jurisdiction); however, these laws were never enforced. These laws were proposed to enable modern, rational and appropriate courts organization. They aimed to decentralize courts system according to future regionalization and decentralization; to change commercial courts status and organization that have to broaden their authority; to develop mechanisms of checking judges' dignity; and to establish mechanisms for judiciary independence greater guarantee. Special innovations in these laws should be: judiciary and judges independency strengthening, establishing of special body for personnel selection - Administration of Justice High Council; independence guarantee by new way of cases allocation to judges; systematic organization, new court categories and their real jurisdiction. Juridical administration reform is reduced to five judiciary laws, and its serious implementation has to happen soon. By now, the basic legal framework[113] have

[113] In order to complete this field, it is necessary to change process laws. For example, Law on legal procedure (system still favors debtors that may unlimitedly drag out court procedures, causing long suites

been composed only, institutions can not implement it, and it is necessary to work on administration and increasing of juridical institution capacity for interpretation and implementation in a predictable, efficient, and transparent manner.

If the five laws passed in 2001 can be characterized as a step forward, although they have not been implemented, Serbian government launched some changes in the middle of 2002, that all can be considered as a step back concerning good reform direction. This changes provoked immediate reaction of experts and judges: "New changes and amendments on judicial administration laws set are dangerous for judiciary independence and suspend legal authority."[114] According to these changes, Administration of Justice High Council are excluded from the process of appointing judges (this body should provide judiciary political independency) and Serbian parliament appoints judges, or more exactly, the parliamentary council of justice. Court presidents should not work on cases, and they so become regime officials and a channel of political influence on court, just like in Milošević and Tito era. Minister of justice, court president, and Supreme Court president control the process of firing judges, and minister of justice announces the application for court president. These changes are adopted by the Serbian government, although they were not discussed in the appropriate parliamentary council (although they should be), what is a precedent illustrating the adherence and commitment of the Government to the rule of law.

Decentralization

Serbia under Milošević is centralized, repealing autonomous regions competences, depriving municipalities' property and concentrating all power in the same hands. Therefore, decentralization has been one of the priorities after "changes" and the DOS leaders have promised it zealously. However, real steps toward country decentralization were insufficient or wrongly conducted.

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with great possibilities for different influences to judges) and Law on executive proceeding, due to efficient implementing of court decision that dissimulate economic activities. Illustration of present situation in this filed it is necessary 40 days to get permissions and licenses; late payment of debt allows 8 weeks, and implementing court procedure lasts 40 weeks.

[114] Vera Šupica, member of Governing Council of Serbian Judges Association in the newspapers **Danas**: Roknić (2002), p. 5.

For example, media, police, and military pressure on **Montenegro**, well known in the period 1997-2000 stopped and this is a positive achievement. However, paternalism towards Montenegro and weaker pressures continue to persist. Although the governing parties in Montenegro opted for independence, one stream of the DOS gathered around president Koštunica was for the creation of federal state, while Đinđić's block was very heterogeneous both containing supporters of the federation and supporters of independent Serbia and Montenegro. NBY and its Governor were often pressing Montenegrin monetary authorities to introduce dinar again and abandon euro. Moreover, the DOS does not have Democratic Party of Socialist (DPS) but Socialist Populist Party (SNP) as a coalition partner in the Federal Parliament, although SNP has been an opposition in Montenegro and it was Milošević's ally since the start of disobedience of Montenegrin authorities to Milošević.

The representatives of Serbia and Montenegro did not managed to redefine the relationships between two federal states, so the EU representatives joined the negotiations and offered the compromise. The Belgrade Agreement was signed in March 2002 and its basic principles are in accordance with the Serbian demands for the international subjectivity and certain common spheres of the future state, but the EU rejected other Serbian demands for strengthening of the federal state.[115] This rejection was concession to the Montenegrin side. This meant that new state would have just a few competences with the veto right for both states. On the other side, it was rejected Montenegrin demand for the union of the two independent and internationally recognized states without single representative in the UN, IMF, WB and the Council of Europe. The duration of the Agreement is limited to three years and after this period expires each of the units would be allowed to opt out. This approach of the EU, tacitly supported by the USA, is an

[115] New state, Serbia and Montenegro has not the government, but the council of ministers with five posts: 1) foreign affair 2) national defense, 3) economic foreign affairs, 4) economic internal affairs and 5) human and minority rights. It is obvious that new state looks like a club, rather then an unit, because it has no common market, tax, custom, and monetary systems. After three years, any club member may leave the club and obtain independence.

[120] There are many exceptions in this group, so for example, UNECE (2002, p. 5) does not rank Serbia and FRY at all, in respect to credit capability. The investment grade list of the UNECE is based on two other lists, composed by private companies (Fitch and S & P), rather than on the basis of political convevniences, what is usuall among international organizations and non-market funds.

obvious attempt to stop the disintegration process and to delay border reshaping[8]. After the signing of the Belgrade Agreement in March 2002, the negotiations between Serbia and Montenegro about the text of the future Constitutional Charter continued in the following months. Instead the parity commissions named by the two parliaments and foreseen by the Belgrade Agreement, the negotiation was conducted by the governments of Serbia and Montenegro, in obvious effort to prevent the loss of the international rents (credits). At the beginning of October 2002, when we are writing this report, the Constitutional Charter is still unfinished.

When it was a part of the SFRY, Serbia had two autonomous regions – Vojvodina and Kosovo. These regions enjoyed significant autonomy since 1974, which was revoked in 1990, when Serbia became a unitary state. After the NATO intervention in 1999, **Kosovo** was practically excluded from Serbia. The UN resolution No.1244, ending up the NATO intervention, states that Kosovo is a part of FRY but not a part of Serbia. Kosovo is currently under protection and governance of the UN and its future is uncertain. Possible alternatives for future status of Kosovo are: a) independence b) joining to Albania c) division between Serbia and Albania d) reintegration in Serbia, but without any Serbian competences over it.

Re-establishment of the autonomy for **Vojvodina** might have been the test for DOS, but it passed this test with very limited success. Instead of giving substantial autonomy to Vojvodina with the original competences (as it was promised in the DOS's election campaign in 2000), so called Omnibus legislation was promulgated in the beginning of 2002. By this legislation the authorities in Belgrade delegated a part of its own powers and funds on the Parliament and Government of Vojvodina. The process of collecting revenues for the Serbian budget and their transfer to the Vojvodina authorities is contrary to the very idea of autonomy. A separate question is, does this correspond to the demands of the autonomy. The Government of Vojvodina got the competences in education, health care, judiciary, culture, social insurance, urbanism, energy supply, agriculture, but it got no responsibility for taxation and privatization. When this Omnibus Law was promulgated, it was said that its provisos would start to apply in autumn 2002, but there has been no indication about real progress in implementation.

In the light of the preceding solutions, the Law on **Local Self-Governance** may be considered as the success of the new regime, although it has significant shortcomings. Positive effects of the law are that municipalities got slightly broader competences and the expenditures on the local level grow from 10% to 16-17% as percentage of the total state expenditures in Serbia. Competences are exclusively local, while elementary education, preventive health care and some other fields may be delegated from the republic to the local level, but it is not mandatory. The experience is that the higher levels are reluctant to transfer competences on the lower level if the transfer is not prescribed by law. Mayors are to be elected directly, but their prerogatives are seriously limited by the prerogatives of the other municipality bodies. Defects of this law are that implementation acts have not been promulgated. It is unexplainable why central authorities have not given back the property to municipalities taken by Milošević in 1996, who did so anticipating the victory of the coalition "Together" on the local elections. There is no reasonable explanation why this property is not back to municipalities: it was enough to nullify the law. Another bed aspect of the law is that there is no possibility for the municipality to influence the tax rates of certain taxes, such as income tax, turnover tax, and corporative income tax. This would be the way to create "fiscal federalism" i.e. a competition between municipalities, which would increase the attractiveness of Serbia as a whole for the private investments.

About some other aspects of the decentralization, such as status of Sandžak, the positions of towns there was no debate after "changes".

The other laws and initiatives

In addition to what is already mentioned, there were some other unsuccessful laws and draft laws. Law on University is technically bed and that is not only because it has 149 articles, like some constitutions, but also because it is too detailed and repeats that University is scientific instead educational institution.[10] The Law is discriminative, strongly favoring state over private universities. Furthermore, there is a discretionary power for the commission (composed of the professors from the state universities) to set the conditions that private universities have to fulfill as well as to approve or reject their programs. This is clear conflict of interests.

Another example of the reforms lagging is a very limited and partial reform of the **public administration.** The whole reform may be summed in establishing the Agency for Public Administration Development and The Council for Public Administration. So far, there is only the Law on Security Intelligence Agency. Files from the secret police archives have been opened very selectively and the majority of individuals that were surveyed by secret police did not want to go and check their files. The full disclosure is the real test of the first forthcoming reform government.

Serbian government was governing by decrees during 2001-2002 and brought more decrees than all Milošević's governments in ten years. It was not in hurry with the transformation of the legal system, because it benefited from the broad prerogatives inherited from the Milošević era, like huge concentration of power and getting rich. Generally, reforms can hardly be conducted without constitutional changes and adequate legislation. For such an effort, Serbia is lacking the political will.

D. THE POSITION OF THE COUNTRY IN THE WORLD

There is an almost shocking difference in appreciation of economic and political situation in Serbia after changes took place when one considers private investors and business on the one side, and the state officials, diplomats, international organizations and non-market funds on the other side. Private investors, funds and think-tanks have estimated in general the reforms in Serbia as insufficient, bad, and even disastrous, while, apart from that, international organizations,[120] some governments and non-market funds estimated the situation in range from good to tolerable. The explanation is very simple.

Governments, organizations and non-market funds have given better marks because of political intrest, what has nothing to do with reforms and real situation in Serbia. For the help to the government of Serbia they did not spend their money, but the money of tax-payers. Contrary to that , private investors, companies, funds and think-tanks directly take the risk of their estimations, their investments are comercial and that is why it is in their interest to be realistic.

There were many favorable appreciations of the reforms in Serbia from some governments, ambassadors in Belgrade, representatives of the IMF, EBRD, EU and WB, but we cite here just one typical: «I am convinced that we are going to witness a significant inflow of foreign direct investment in Yugoslavia in forthcoming months. ... A number of investors will come here, with the main American investors among them. (...) It is true that investors take care a lot the political stability and economic situation. But, your team did excellent job and it has laid down grounds for a stable economy. For that reason, I am the optimist.»[121] There was a number of statements of that type, even several from the cited author, but from investments not a bit. Investors would come, provided there is a suitable environment for doing business.

In the remainder, we will be confined to some estimations which are either realistic or controversial, because of contradiction they contain.

The example of a controversial estimation is EBRD (2002), which emphasizes «a coherent approach to transition and reform» (p. 4) of the Serbian and Yugoslav authorities, «/A/gressive reforms, to which the authorities have already shown their strong commitment...»[122] (p. 4), but it is still underlined that the reforms are «at the early stage of transition» (p. 4). If it is so, the results are to be expected. But, instead of that, the EBRD says: «Now that reforms have taken hold and relations with the international community have been restored, the potential exists for a strong rebound over the medium term. In the short term, however, economic growth is likely to be constrained by the legacy of dilapidated and obsolete infrastructure, lack of working

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[121] William Montgomery, the U.S. ambassador in Yugoslavia in his interview for daily **Danas**, in: Jaukovic 2002, p. IV.

[122] EBRD adds: » A comprehensive and fast reform programme has been embarked upon aimed at establishing, after a long period of authoritarian rule, a democratic system based on the rule of law.« (s. 3) It is interesting where EBRD finds such phenomena, although the presidency of DOS rather than the Parliament takes crucial decisions, although the Government creates the members of Parliament as it likes that, although the Serbian Government and the majority in authority skip to enforce court decisions when their verdicts are not suitable for them. In addition, there still have not been any reforms in attorney, in the police and in the court system. "The year 2001, the first year of a new political and economic system, saw remarkable progress in transition in FRY." (ibid, p. 4, underlined by the editor). It would be nice to reveal where are a new system and a remarkable progress.

capital, unclear ownership and depleted level of social capital and institutional development.» (p. 13)

Estimates of the «Economist Intelligence Unit» are more realistic what concerns wording, but they are very unrealistic in growth figures. The EIU emphasizes a «slow progress» in the sphere of technical economic politics and adds: “Privatization is a difficult area, but impetus is building up here too. More problematic are flanking reforms in such areas as law and order, and coorporate government, without which the tehnical economic reforms will not have full impact. Progress in this area is extremely slow, and full resolution of these issues may take decades rather than years. (...) A key underlying problem in all this is that the economy now largely revolves around foreign aid, which provides finance but offers no technology transfer, which is what the country needs most.»[123] The EIU emphasizes «the impressive price stability» and it says that the greatest risks for macroeconomic stability are in decline of foreign aid and revenues from privatization.[124]

«Freedom House» in the «Nations in Transit» for 2001 rankes 27 transition countries according to the degree of democracy, the rule of law and economic liberalization. FRY shares 18-19th place according to the degree of democracy, 22-23rd in respect to the rule of law and it is 22nd in respect to the economic liberalization.[125] According to all of the three markers FRY is the very last among 15 transition countries in Central and East Europe.

In the period from 1994 - 2001. FRY (and Serbia) has not been ranked on the list of economic freedom created by «Heritage Foundation» and «The Wall Street Journal». For the first time FRY has been ranked in 2002. and it got 144th place out of 155 places, with 4.05 index points. According to the degree of economic freedom FRY belongs to the very last , fourth group of countries with «not-free economy».[126] The

[123] EIU, July 2002, p. 3.
[124] EIU, July 2002, p. 12.
[125] See “Nations in transit” 2001, p. 25, “Freedom House” web site. The research includes period from October 31, 2001, so for FRY it was estimated only the degree of democracy after getting rid of Milošević, but not other changes which occurred later on.
[126] With 1 (one) marking the highest, and 5 (five) representing the lowest level of economic freedom. See www.heritage.org On the top of the list is Hong-Kong (1st place, index 1.35), Singapore (2nd, 1.55), New Zealand (3rd, 1.70), Estonia, Ireland, Luxembourg, Great Britain, The Netherlands and The USA (4-8th, all 1.80). Among the countries in transition, apart from already mentioned Estonia, the best ranked are Czech

index is based on 50 indicators, arranged into 10 groups, and for the index of 2002 concerned, the data stem from the period untill July 2001. However, even when the new index for 2003 appears, the position of FRY will not be improved, due to negligible reforms it did. Out of the ten counted components, which are taken into account when the index is reckoned, FRY got the highest marks in fiscal burden of the government (2.5), state intervention in economy, the level of freedom in setting prices (3.0). For trade politics, banking and finance, property rights, FRY got 4.0. In monetary policy, capital flows and FDI, regulation, grey market, FRY got the lowest mark (5.0).

According to the ' Index', it seems that reforms in FRY and Serbia are only to come. Since there are not prosperous countries under index of 2.70 (it means that all developed and fast growing countries are under 45th place on the list), it is certain that the way to that society leads through fast and deep changes towards free market.

FRY and Serbia are not ranked on the list of economic freedom worked out by the «Fraser Institute» from Vancouver, which is considered to be the most important in the world, along with the Heritage list. Private investors pay much attention to these lists, so with that and with bad business environment in Serbia, one can explain why the country is not ranked well in respect to «investment grade» among private investors and companies in the world.

Among the rare companies and think tanks ranking Serbia and FRY, usual marks are CCC, DDD, 6d or C3, which are the lowest marks in their ranking sistems. For example, famous U.S. data base for investors, «Dun and Bradstreet», ranks FRY in 2002 at the very last place among 24 ranked transition countries. FRY is graded for 6d.[127] No significant flow of FDI can be expected until a country comes to the marks BaB, Baa2 or at least BBB, B1 and similar, which are the marks of better but not the best transition countries. It is important to notice that these marks reflect the (un)conveniences for private investment rather than issues like political cooperation of the country in international relations, credibility of government to take credits on international market, or fine work of bureaucracy.

Republic and Hungary (32nd and 33rd, both 2.40), and the worst off ranked are Tajikistan, Ukraine (137th and 138th, both 3.85), Bosnia (140th, 3.90) and FRY (144th, 4.05). Among the ex-SFRY, Slovenia is 79th, with 3.10, Macedonia 97th, with 3.25 and Croatia 108th, with 3.40.

[127] Dun & Bradsteet ranks Slovenia and Hungary on the first place. Croatia is graded 4d and ranked 4th.

There is only one way how to improve the economic position of Serbia, and that leads via improvement in the rule of law and further liberalization of the market. If the significant changes in that direction were made, the improvement would be almost immediately felt by better ranking on country-lists, and confirmed by private investors through larger flow of investments.

E. GENERAL EVALUATION OF REFORMS

Serbia has demonstrated its immaturity and inability to solve its problems on its own. The country has bankrupted at the beginning of 1990-ies, the international community was induced to arbitrate in disputes emerging from dissolution of former SFRY (including military interventions in Bosnia and on Kosovo), in mediating negotiations among ex-Yugoslav countries related to a fair division of inherited common goods, in mediating between Serbia and Montenegro over their common government. Finally, the international community has used "stick and carrot" policy to encourage Serbian leadership for cooperation with the ICTY of in the region. Inability to perceive some type of a market democracy under the rule of law as the main reform objective belongs to mentioned immaturity as well.

It is probably not realistic to expect enthusiastic market reforms in Serbia comparable to those in Estonia[128] or Hungary. Even if one accepts such a position, it would be difficult to explain, why then a more moderate reform is missing too, like that in Slovakia or Bulgaria. It is true that reforms cannot be implemented overnight, but it is also clear that a commitment for reforms does not need months to be shown. Even such a commitment to reforms is missing in Serbia.

After changes in 2000 took place, a number of independent experts from Milosevic era got important official positions, and this woke up hopes in fast and deep

[128] It is sometimes said, Serbia was in difficult position in 2000, and such countries cannot conduct enthusiastic reforms. This is a wrong argument, since some transition countries were in a worse position when started reforms, like Estonia: "But after 50 years of Soviet occupation, Estonia was in ruins. Our economy was a shambles, the spirit of our people spoiled by the socialist heritage. Shops were empty of goods and money no longer had any value. Fuel prices rose by more than 10,000% over one year, while inflation was running more than 1,000% per annum. People stood for hours and hours in lines to buy food". Laar, 2002, p. 4. Situation in Estonia in 1991 was apparently inferior to that in Serbia 2000. However, the Estonian leaders were committed to reforms, while the Serbian ones were not.

reforms. This, however, never happened, since these experts have accepted socialist legacy and even became their apologists[129] in the meantime.

It is not easy to publicize such moves in larger media today, since the government controls media[130] in Serbia in a very similar way Milosevic did it. No wonder that the government tries to marginalize critical experts, since they are unison in evaluating "reforms". It prevails general conviction among them, that "…transition is still missing", and this is the reason for why "after coup in 2000 there was none encouraging economic trend"[131], that "macroeconomic trends in FRY are unfavorable"[132], that there was no reforms in Serbia in 2002,[133] and that improvement may not be expected before structural changes are undertaken.[134]

In euphoria about "reintegration of Serbia into international community" and in providing assistance for the country to avert a humanitarian disaster in winter 2000/2001, the impact of foreign aid was neglected by and large. Foreign aid was conditioned by some political objectives rather than by reforms. Claims for further democratic reforms, implementation of the rule of law (including reforms of state agencies, army and police) were missing. Aid providers have not asked for deeper economic reforms. Foreign financial aid has just replaced bankrupted central planning. Politicians have used it to please interest groups while buying time in office.

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[129] Especially characteristic is the case of experts from Group 17 (G17), which were critical to Milošević's system, but which accepted his system with the modest changes and so forgot their initial economic program from 1996. That program was not a blessing of free market, but nevertheless, it represented a basically market philosophy with heavy regulation. G17 became in the meantime a rent seeking and opportunistic group, being publicly silent about wrong policy moves.

[130] This has already become an issue for relevant organizations, like Amnesty International, Human Rights Watch, SEEMO, and even for the U.S. Congress.

[131] Prof. dr. Ljubomir Madžar, in: Barjaktarević (2002), p. 1.

[132] Raičević & Šuković (Ed)(2002), Forward, p. 7.

[133] By talking about influence of political instability on reforms, Vladimir Gligorov writes: "Parliamentary bodies are not respected, and political opponents get all kinds of labels. That, in my opinion, will not endanger reforms, which are next to nonexistent this year, but it will prolong and enhance political instability." Gligorov 2002a, p. IV. Our italics.

[134] Cf. columns by Dr. Milan Kovačević in daily Blic. Cf. also articles in press written by members of the FMC.

[136] The slogan "Serbia on the right path" irresistible reminds on "Scandiaconsult on the right path": "In 1999 *Scandiaconsult* adopted a business plan for the period 2000-2004. This plan was implemented throughout the company during 2000 in a project known as 'On the right path'." Citation from the site: http://www.scc.se/english/strategic_focus/index.shtml Serbian government has not reacted when the daily **Danas** (**Today**) has published a FMC article, in August 2002, about apparent theft. Instead, the Serbian government launched a new pseudo-campaign in September 2002, now under the slogan "Proud for Serbia".

It is very simple to understand what happened in Serbia in the last two years. By getting a significant foreign aid, the DOS politicians simply avoided reforms, since reforms are costly. Anyway, politicians waited on first post-Milosevic elections in order to divide the cake. For that reason Djindjic's government paid a lip service to reforms, and spoke about "the government that has not alternative", while preserving *status quo* in reality and using foreign aid to make an impression that people live better.

Provided the foreign aid was more moderate or conditioned, the authorities would be forced to think about reforms. By getting aid, they were able to keep a low profile in new legislation and to sell just three cement factories and few dozens of small enterprises. Authorities believed, a slow development in privatization should prevent a significant rise in unemployment. Such policies were short sighted, since donations and soft credits cannot last forever. The DOS government enters a scenario where the number of open questions and troubles grows instead to be smaller. Instead to await regular elections in 2004 after the most difficult reforms and post-reform recession are over, while the first positive results emerge, the authorities will face new elections with thin donations, not reformed real sector and rising tensions.

Like all politicians not having real results, prime minister Djindjic and Serbian government suffer from pseudo PR campaigns, in an effort to promote allegedly results, which naturally do not exist in reality. In spring 2002 they started the campaign "Serbia on the right path". Beyond the fact that something like that was unfounded, it turned out that the slogan itself was illegitimately[136] taken from "Scandiaconsult".

Not reformed Serbia is exposed both to economic and political risks. Economic risk arises from non-reform environment. Current macroeconomic stability does not rest on real and stable ground. It is achieved without microeconomic stabilization, i.e. without transformation in the real sector. For that reason, microeconomic "stabilization" borrows from the macroeconomic one. This operation is very temporary, since macro-equilibrium is not based on micro-equilibrium. The former one is temporary financed through donations, soft loans and privatization revenues. A reduction from these sources will exercise pressure on macroeconomic level and cause a new equilibrium. That pressure will cause a crisis in Serbia in 2004-2006, comparable to that in Bulgaria from 1996.

Political risk includes bad political options that persist as political options for future, since there was no real reform to remove them. To put it the other way, the first function of reform would be to exclude bad political options, like communism and national-socialism. Another basic function of reforms would be, to provide better material and other environment for life. That would induce voters to accept changes, i.e. a market democracy under the rule of law. Since there were no serious reforms, bad conceptions are still eligible, with either elections or social unrest being catalytic.

F. EXPECTATIONS

Optimistic expectations about Serbia as a country of large chances, investment and significant prosperity will stay unfounded until it breaks up with socialism and etatism. However, there is a negligent probability for this to happen, since the majority of voters and all larger political parties are pervaded by the spirit of collectivism and regulation. It is much more probable that the current trend of extensive regulation, bureaucratic management of economy and high taxes will continue. For that reason Serbia in the long term will stay among two or three worst placed European transition countries.

There will be no larger and significant legislative changes until the end of 2002. It is expected a growth rate up to 2%, inflation rate of 16-20%, budgetary deficit of 5-6% from GDP, trade deficit of some 73%, further rise in unemployment rate for at least 10.000 jobs lost per month (with a slow rise in employment in private sector, able to wipe out some ¼ of those losing jobs). It is also expected a very slow devaluation of dinar, concerning hard currencies, and FDI's of up to 130m USD. Very similar results may be expected in 2003 too, with slightly lower inflation rate (up to 15%) and eventually larger unemployment rate. Beyond 2004, current temporary macroeconomic equilibrium is going to decay, caused by lower donations and privatization revenues. This trend may be speeded up, if the U.S. Congress blocks aid to Serbia, and if the U.S. starts to vote against Serbia in IMF, WB, etc.

Thinking in the long term, Serbia will stay relatively stagnant country until 2010, with an average growth rate of 2%, rather lower FDIs (they will move from 120m to 300m USD per annum), and average inflation rate close to two digits. Large trade deficit will continue to exist at least until 2004-2006, and thereafter it will decline. Budgetary deficit will move 3-7%, and the largest will be in 2004-2006. This forcast allows fluctuations in some years, and it does not take into account eventual external shocks.

The development described above may not be averted in any other way but through reorientation of public policies towards enthusiastic reforms, directed to the improvement of economic freedom and the rule of law. Specific content of this reorientation is contained bellow in «Recommendations». Relative succes depends on how deep, fast and sincere that eventual reorientation is going to be. For larger improvement and growth rates around 6-7%, it is necessary to improve the state of affairs in next to all relevant areas. Partial improvement or a very small improvement in all areas cannot create results significantly better from those envisaged in «Expectations».

G. POLICY RECOMMENDATIONS

General recommendation for Serbia would be a fast and deep market reform, what is equivalent to quick and systematic leaving of collectivism and extensive planning and regulation. Steps in this direction include:

- complete protection of private property and enforcement of private property rights;
- full respect for freedom of contract;
- legislation of new, liberal commercial laws;
- radical simplification of procedures for start up businesses and operational conditions;
- further liberalization of foreign trade, by reducing average tariff rate to 3% or lower, and removal of all formal and informal non-tariff barriers;
- further liberalization of internal market by freeing all prices including utilities (after privatization);
- fast privatization of all sectors, with special care for 100 or less largest enterprizes;
- restitution of property nationalized by communists after the IIWW;
- legislation of bankrupcy law, and enforcement of liquidation law;
- new anti-monopoly legislation and its strict enforcement;
- systematic stimulation of competition on the market;

- introduction of arbitrage councils for solving conflicts among firms in main branches; larger role for comercial courts, including shorter period for settling the cases;
- introduction of euro (or dollar) as a paralel currency to dinar, and removal of all measures aiming to privilege the national currency;
- removal of restrictive regulation of the banking sector, and complete liberalization of private and capital transactions in and outside the country;
- liberalization of securities market, withdrawal of ban for Serbian citizens to buy foreign securities;
- introduction of the simple and transparent tax system, with low and flat tax rates, without tax exemptions and special cases; introduction of the VAT of up to 10%, and reduction of the corporate tax and personal income tax to the level that is going to be competitive in the region;
- reduction in state expenditures from 54% to less than 30% during several years;
- decentralization of the country (larger responsibilities for municipalities, introduction of regions, authonomy for Vojvodina and Sandzak, etc.);
- allowing fiscal federalism, i.e. tax competition among jurisdictions;
- step by step legalization of gray economy by changing incentives rather than by power of law;
- sincere, efficient and systematic fight against corruption and crime, based on the positive approach described above;
- reform of the state administration, police and army, including tight civilian control over them;
- strict respect of division of power, and full independence for judicial sistem;
- reform of judicial system based on the rule of law;
- removal of censorship and indirect control over media, privatization of state owned media (with exception of one radio and one TV channel);
- liberation of NGO's and strict respect of demarcation lines between the state, private and NGO sector.

Prosperity cannot be achieved by political means – it may result just from a huge rise in private investment. Serbia will not make economic advances without essential improvement in fostering individual freedom (including economic freedom), constitutionally very constrained government and the rule of law. The attractivity of these values will rise with the flow of time, both because the country has never tried that path and because it has tried dead ends – from tribalism and socialism, to self-management, nationalism, and national conservatism. These policies brought huge costs and nearly no advantage. Naturally, changes in positive direction cannot happen without corresponding changes in preference among voters and politicians.

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«Two Years of Reform in Serbia: A Wasted Opportunity» is in my opinion one of the best economic and political publications in post-Milosevic's Serbia. I believe this study represents not only an excellent criticism of economic policy from October 2000 to now, but also an important source of information for the citizens in Serbia about the gap that always exists in a paternalistic state between promises and reality. I would not be surprized if many members of the Serbian leadership pose the question, whether it is the right time to publish something like this. Socialist habits of avoiding the truth do not die easily. However, the principles of freedom require that the public is informed about discrepancies between promises and economic reality in Serbia. The insistance on truth in an environment that was fed by lies for more than six decades gives this study a great importance. For those reasons I welcome the publication of «Two Years of Reform in Serbia: A Wasted Opportunity».

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